ISLAMIC FINANCE INDUSTRY IN LEBANON:

HORIZONS, ENHANCEMENTS AND PROJECTIONS

by

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Abstract

The Islamic Finance industry has been growing at a rate of 15 to 20% in the past two decades. The Lebanese government and the Banque du Liban, Lebanon's Central Bank, promulgated several laws and circulars to regulate this industry in 2004. However, the market volume of the Islamic financial operations was not to the expectations of the regulator. This thesis researches the reasons for which this industry did not experience a representative volume of operations in the Lebanese market. We proceed by conducting a qualitative market analysis, interviewing the major players and officials concerned with this industry. A quantitative study relying on secondary data for Lebanon, Bahrain, Qatar and the UAE will back up our qualitative inferences. We present an evaluation and a criticism of the present legal framework, suggesting the necessary amendments to improve it. We investigate and tap unexplored terrains of Islamic Finance instruments and modes of finance in Lebanon. The study concludes by suggesting application of Islamic Financial instruments to securitization, privatization, SMEs and agricultural support, microfinance and Islamic funds. This would boast the volume of operations of Islamic financial institutions in Lebanon.

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Ghassan Chammas
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Dedication

To His Excellency

Dr. Ahmad Jachi

First Vice Governor of Banque du Liban

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Glossary[1]

Al -kharaj bildaman:	The Islamic legal principle that means entitlement to revenue follows assumption of responsibility. Profits, therefore, are based on the ownership of, and responsibility for, capital.
Bai al-dayn:	Sale of debt or receivables.
Bai al-inah:	A loan in the form of a sale, called *inah* (façade) because it is a sale in appearance only. This is accomplished by one's buying back what one has sold for a lower price than that for which one originally sold it. The difference, ostensibly profit, is actually a loan.
Bai al wafa':	A sale with the right of redemption, literally, a sale of honor. Typically, such a sale takes place when a commodity is sold on the condition that the seller be allowed to redeem the commodity upon paying its price; and the buyer agrees to honor the condition
Bai bithaman ajil:	Differed payment sale, credit sale.
Daman/Kafala:	Guaranty or surety.
Fatwa:	an authoritative legal opinion based on the Sharia (Islamic law).
Fiqh:	Practical jurisprudence or human articulations of divine rules encompassing both laws and ethics. As such, *fiqh* may be understood as the jurists' understanding of the Sharia, or jurists' law.

[1] Glossary compiled by Miss Maria Khalaf (ESA-Beirut, MeM), using various references such as : Euromoney, Islamic Finance innovation and growth. Mr. Jean-Marc Riegel Islamic finance instruments, ESA 2005, and various Islamic industry's literature.

Fiqh al mu'amalat: Islamic commercial jurisprudence or the rules of transacting in a Sharia compliant manner.

Fuqaha: Pl. of *faqih*, qualified specialists in *fiqh*, or jurists.

Gharar: Uncertainty in a contract of exchange as to the existence of the subject-matter of the contract and deliverability, quantity or quality of the subject-matter. It also involves contractual ambiguity as to the consideration and the terms of the contract. Such ambiguity will render most contracts void.

Hadith: The narrative record of the, sayings, doings, and implicit approval or disapproval of the Prophet, peace be upon him. The world is sometimes used in English as a collective noun; sometimes an "s" is added to make the plural.

Halal: Lawful; one the five major Sharia categorizations of human acts.

Hamish gedyyah: Security deposit. An amount of money paid by the purchase order upon request of the seller to make sure that the order giver is serious in his order of the asset. However if the promise in binding and the purchase ordered declines to purchase the asset, the actual loss incurred to the seller shall be made good from this amount.

Haram: Unlawful; one of the five major Sharia categorizations of human acts.

Ijara: The transfer of ownership of a service for a specified period for an agreed upon lawful consideration.

Ijara mountahia bittamleek:	This is a form of leasing contract used by Islamic financial institutions, which includes a promise by the lessor to transfer the ownership of the leased property to the lessee, either at the end of the term or the lease period or by stages during the term of the contract. In this form of leasing contract, the title to the lease is executed by means of a promise to give it as a gift for no consideration or as a gift contingent upon the payment of the remaining installments or a promise to sell for a token or other consideration, or by accelerating the payment of the remaining installments or by paying the marked value of the leased property.
Ijm'a:	The consensus of jurists; considered a binding legal indicator (*dalil*) in the classical jurisprudence.
Ijtihad:	Effort or toil (literally) as a legal term it means the effort of a qualified Islamic jurist to interpret sources of Islamic law. Thus, while every toiler or *mujtahid* is a jurist (*faqih*), not every jurist is a *mujtahid.* This is because many jurists serve merely to bear on convey *fiqh*, while others (through *ijtihad*) actually produce it.
Ihtikar:	Monopoly.
Ikhtilaf:	Divergence of opinions among jurists.
Istihsan:	Judicial preference for one legal analogy over another, usually in view of the public welfare.
Istisna:	A contract of sale of specified goods to be manufactured with an obligation of the manufacturer to deliver them upon

completion. It is a condition in *Istisna* that the seller provides either the raw material or cost of manufacturing the goods.

Jahala: Lack of knowledge or ambiguity in the terms of a contract.

Khiyar al-shart: An option in a sale contract concluded at the time of signing the agreement, giving one of the two parties to the contract a right to cancel the sale within a stipulated time.

Manfaa: Usufruct or benefit derived from an asset.

Maqasid: The general objectives of Islamic law.

Mudaraba: A partnership in profit between capital and work. A *Mudaraba* is typically conducted between investment account holders, as providers of funds, and the Islamic bank as a *Mudarib* (see below). The Islamic bank announces its willingness to accept the funds of investment account holders, the sharing of profits being as agreed between the two parties, and the losses being borne by the provider of funds, except in case of managerial misconduct, negligence or violation of the conditions agreed upon the Islamic bank. A *Mudaraba* contract may also be concluded between Islamic bank, as a provider of funds, on behalf of itself or on behalf of investment account holders, and business owners and other craftsmen, including farmers, traders, etc.

Mujtahid: Legal expert, or a jurist who expends great effort in deriving a legal opinion or interpreting the sources of law.

Mudarib: The managing partner in a Mudaraba (see above).

Murabaha: Sale of goods with an agreed upon profit mark-up on the cost. There are two types of *Murabaha* sale. In the first, the Islamic bank purchases the goods, makes them available for sale without any prior promise from a customer to purchase them, and is termed a normal or spot Murabaha. The second type typically involves the customer's promise to purchase the item from the institution, which is called Murabaha to the purchase orderer. The customer distinguishes it from the normal type of Murabaha that does not involve such a promise. The Murabaha to the purchase order is the sale of an item by the institution to a customer (the purchase orderer) for a pre-agreed selling price, which includes a pre-agreed profit mark-up over its cost price, this having been specified in the customer's promise to purchase. Normally, a *Murabaha* to the purchase order transaction involves the institution granting the customer a *Murabaha* credit facility. A *Murabaha* to the purchase order transaction typically involves deferred payment terms, but such deferred payment is not one of the essential conditions of such transactions. A Murabaha can be arranged with no deferral of payment. In this case, the mark-up will only include the profit the institution will receive for a spot sale and not the extra charge it will receive for deferral of payment.

Musharaka: A form of partnership between the Islamic bank and its clients whereby each party contributes to the partnership capital in equal or varying degrees to establish a new project or to share in an existing one. Each of the parties becomes an owner of the capital on a permanent or declining basis and shall have his due share of profits. Losses, however, are shared in proportion to

the contributed capital. It is not permissible to stipulate otherwise.

Qard Hassan: A loan *per amore* in which there is no interest. In Islamic law, all loans are gratuitous contracts.

Qura'n: The Book of Divine Revelation that was delivered to humankind by the Prophet Mohammed, peace be upon him.

Rab al-mal: Investor or owner of capital in a Mudaraba contract.

Riba: Interest; sometimes, equated with usury, though its means is somewhat broader. Its prohibition is meant to distinguish an unlawful exchange (in which there is a clear advantage to one on the contracting parties) from a lawful, mutually beneficial exchange and lawful loan.

Salam: A contract for the purchase of a commodity for deferred delivery in exchange for immediate payment according to specified conditions.

Sharia The term Sharia has two meanings: Islamic law, and the totality of divine categorizations of human acts (*Islam*). The second meaning of the term means Sharia rules do not always function as rules of law in the western sense, as they include obligations, duties and moral considerations not generally thought of as "law". Sharia rules, therefore, admitting of both a legal and a moral dimension, have as their purpose the fostering of obedience to the Almighty. In the legal terminology, Sharia means the law as extracted by the *mujtahids* from the source of law.

Sukuk: Participation securities; coupons, investment certificates.

Sunnah: The way of the Prophet Mohammed, peace be upon him, including his sayings, deeds, approvals or disapprovals as preserved in the *Hadith* literature: the second of the two sources of revelation.

Takaful: A Sharia-compliant system of insurance in which the participants donate part or all of their contributions, which are used to pay claims for damages suffered by some of the participants. The company's role is restricted to managing the insurance operations and investing the insurance contributions.

Ulema: Pl. of '*alim*, Sharia scholars or jurists.

Urboun: Earnest money. It is the amount paid by the client (orderer) to the seller after concluding a contract of sale, with the provision that the contract is completed during the prescribed period. The *urboun* amount will be kept by the seller if the buyer fails to execute the contract.

Usul al-fiqh: Islamic legal theory.

Wadia: Safe-keeping/resale of goods with a discount on the original stated cost.

Wakala: Agency. An agency contract that may include in its term a fee for the agent.

Zakah: Literally, it means blessing, purification, increase, or cultivation of good deeds. In Sharia, it is an obligation in respect of funds paid for a specified type of purpose and for

specified categories. It is a specified amount prescribed by Allah Almighty for those who are entitled to *Zakah* as specified in the Qur'an. The word *Zakah* is also used to indicate the amount paid from the funds that are subject to *Zakah.*

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Chapter 1
Introduction

''That is because they say, trading is only like usury and Allah has allowed trading and forbidden usury'' *Surat Al Baqara v.275*

The aspiration of Muslims all over the globe to implement the Sharia principles into a concrete financing reality have helped in the second half of the 20th century the creation of Islamic Financial institutions throughout the world. Lately, the introduction of Islamic finance in countries not members of the Organization of the Islamic Conference such as the United Kingdom and Singapore has enlarged the client base of such Islamic institutions to non-Muslims attracted by the high standards of ethical investment guidelines of this industry. This follows a similar trend experienced in countries with mixed communities in the Middle-East and South East Asia. These institutions are Commercial Islamic banks, investment Islamic banks, Takaful[2] institutions and Islamic financing houses.

The idea behind the establishment of these Islamic financial institutions is to mobilize the resources to finance productive activities and consumption needs. The essential rationale behind this resources mobilization is PROFIT AND LOSS SHARING (PLS), rather then interest payment or time value of money.

The Islamic ban on interest does not mean that capital is costless in an Islamic system. Islam recognizes capital as a factor of production but it does not allow it to be remunerated by interest in any form. This obviously poses the question as to what will then replace the interest rate mechanism in an Islamic framework. There have been suggestions that PLS can be a viable alternative (Kahf l982)[3]. In Islam, the owner of capital can legitimately share the profits made by

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[2] For a complete reference on the instruments of Islamic finance, please see Appendix 1. Takaful, is the Islamic financial equivalent of Insurance.

[3] Kahf, Mounzer (1982), *Saving and Investment Functions in a two-sector Islamic Economy,* International center for research in Islamic economics, King Abdul Aziz University, Jeddah, KSA.

the entrepreneur. What makes PLS permissible in Islam, while interest is not, is that in the case of the former it is only the profit-sharing ratio, not the rate of return itself that is predetermined.

"It has been argued that profit-sharing can help allocate resources efficiently, as the profit-sharing ratio can be influenced by market forces so that capital will flow into those sectors which offer the highest profit- sharing ratio to the investor, other things being equal. One dissenting view is that the substitution of profit sharing for interest as a resource allocating mechanism is crude and imperfect and that the institution of interest should therefore be retained as a necessary evil (Naqvi l982). However, mainstream Islamic thinking on this subject clearly points to the need to replace interest with something else, although there is no clear consensus on what form the alternative to the interest rate mechanism should take. The issue is not resolved and the search for an alternative continues, but it has not detracted from efforts to experiment with Islamic banking without interest. "

by Mohamed Ariff, University of Malaya,
taken from Asian-Pacific Economic Literature, Vol. 2, No. 2 (September 1988), pp. 46-62

Islamic banking has five distinguishing features:

(a) It is interest-free,

(b) It is multi-purpose and not purely commercial, and

(c) It is based on risk sharing and strongly equity-oriented

(d) It prohibits speculative behaviors and uncertain transactions

(e) It limits transactions to Sharia compliant activities (no arms, no pork, no alcohol, no nightclubs and no gambling).

The literature contains hardly any serious criticism of the interest-free character of the operation, since this is taken for granted, although concerns have been expressed about the lack of adequate interest-free instruments. There is a near-consensus that Islamic banks can function well without

interest. An International Monetary Fund study by Iqbal and Mirakhor[4] (l987) has found Islamic banking to be a viable proposition that can result in efficient resource allocation. The study suggests that banks in an Islamic system face fewer solvency and liquidity risks than their conventional counterparts. The multi-purpose and extra-commercial nature of the Islamic banking operation does not seem to pose intractable problems. The abolition of interest makes it imperative for Islamic banks to look for other instruments, which renders operations outside the periphery of commercial banking unavoidable. Such operations may yield economies of scope. But it is undeniable that the multipurpose character of Islamic banking poses serious practical problems, especially in relation to the skills needed to handle such diverse and complex transactions (Iqbal and Mirakhor l987).

Islamic banks at large are indeed an elaborate model of a conventional bank, a merchant bank and a development bank, blending them in an INTEREST-FREE and Sharia compliant activities. Various non-banking services could be encountered in an Islamic Bank: trust, fiduciary, factoring, real estate, consultancy and business development, to name a few. Many of these activities listed go beyond the realm of commercial banking and are of so a sophisticated nature that they require specialized teams of professionals to deal with them.

It is clear, there is more to Islamic Banking then the abolition of interest. Hence, the scope of the Islamic banking system, its nature and its outlook are distinctly different from those of a conventional bank. Unlike the conventional banks that depend on collateral guarantees and non-participation in risk, Islamic banks rely heavily on project evaluation, especially for equity-oriented financing (Mudaraba). Thanks to the PLS nature of its operations, bank-customer relations are much closer and more cordial then is possible under conventional banking. In this respect, one can argue that the ultimate goal of an Islamic bank is making profits while collaborating in the social and economic welfare of the society.

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[4] Iqbal, Z. and Mirakhor, A. (1987). “Islamic Banking”. Al-Tawhid, Vol. 4, No. 3. : *A Journal of Islamic Thought and Culture.*

In fact one of the main selling points of Islamic banking is that, unlike conventional banking, it is concerned about the viability of the project and the profitability of the operation. It is especially in this sense that Islamic banks can play a catalytic role in stimulating economic development. In many developing countries, of course, development banks are supposed to perform this function. Islamic banks are expected to be more enterprising than their conventional counterparts are. In practice, however, Islamic banks have initially been concentrating on trade finance, which is the least risky.

Part of the explanation is that long-term financing requires expertise, which is not always available. Another reason is that there are not yet backed-up institutional structures such as secondary capital markets for Islamic financial instruments. It is possible also that the tendency to concentrate on short-term financing reflects the early years of operation: it is easier to administer, less risky, and the returns are quicker. The banks will learn to pay more attention to equity financing, as they grow older.

Two basic approaches[5] were adopted by several countries to suppress Interest from their financial systems:

1- Some countries, like Iran, Pakistan and Sudan, opted for suppressing the Interest from all their financial operations at the same time.
2- Other countries, including some non-Muslim countries, allowed the creation of Islamic financial institutions along with the existing conventional financial institutions. Lebanon belongs to this category, and the law 575[6] of 11 of February 2004, regulates the creation, operation and control of Islamic banks and Islamic financial institutions in the country.

Islamic financial services and products are increasingly recognized as having the ability to become a viable option to the range of financial services and products available in international

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[5] M Chapra,Umar, & Tariqullah, Khan (2004), " Règlementation et contrôle des banques Islamiques", étude spéciale No.3- Islamic Development Bank IDB, Institut Islamique de recherché et de formation, p.19.

[6] See the translation of this law and its circulars in the Appendix B.

markets today. Enhanced efforts at development and promotion internationally have seen the establishment of the Dow Jones Islamic Market Index, the FTSE Global Islamic Index series and the like. This is a clear recognition of the tremendous potential of Islamic services and products by the global community.

Today, there are more than 200 Islamic financial institutions operating in 48 countries with combined assets in excess of US$250billion and an annual growth rate of 12-15%[7]. The Union of Arab Banks is even more optimistic. Mr. Joseph Torbey, president of the Union of Arab banks estimates that Islamic banks around the world have achieved an annual growth rate of 15 to 20 percent over the last few years, and currently have $262 billion in combined assets. Roughly, 265 Islamic banks collectively handle investment portfolios worth $400 billion, and have $202 billion in deposits and $13 billion in capital.

The size of Islamic equity funds globally is approximately US$3.3 billion, with an annual growth rate of more than 25% over the past seven years, while the size of Islamic bonds globally is said to be US$25billion. Still, this represents a minute portion of the overall market. Thus, the potential for the industry to grow is tremendous.

Lebanon has introduced recently several laws and circulars regulating the Islamic Financial industry and institutions.

Where does Lebanon stand in this new industry vis-à-vis its neighboring countries?

Clearly, the volume of operations cannot be compared. Yet, what are the features of the newborn Lebanese Islamic financial industry?

What is the impact of its regulations on the performance and competitiveness of this industry?

What should Lebanon do to promote and project this new industry and to attract global investors?

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7 El Hawary, Dhalia & Grais, Wafik &Iqbal Zamir (2004), "Regulating Islamic Financial Institutions: The Nature of the Regulated", World *Bank Policy Research Working Paper 3327*.

Chapter 2
Islamic Financial industry in Lebanon

2.1 Introduction: Present regulatory status of the industry.

Basking a traditional banking and financial high standing acumen, Lebanon could not stand aback from the need of a modern and progressive Islamic Finance regulatory framework. Although Lebanon's market volume could not be compared with its oil rich neighboring countries[8], the Regulator and the government strongly believe that the financial institutions of Lebanon have a potential role to play in the Islamic Financial industry.

In his allocation addressed to the IFSB[9] summit, H.E. Dr Ahmed Jachi, Vice Governor of the Banque du Liban, outlined the need of a future road map for this industry to grow and integrate the global financial system:

"Remarkable progress has been achieved in the field of Islamic Banking since its inception thirty years ago. However, despite of a wide geographical expansion and significant growth, the industry continues to face tremendous challenges, mainly its need to be fully integrated in the global financial system. Such integration requires from the concerned authorities, including central banks, Sharia scholars, legal and tax specialists, and experts of Islamic financial institutions, to combine their efforts in establishing a roadmap, in order to strengthen the industry, enable it to meet the challenges, and achieve the appropriate status."

Dr. Ahmad Jachi's Speech, Delivered at the 3rd Islamic Financial Services Board Summit Thursday, May 18, 2006.

Lebanon's regulator bodies, oriented towards the development and growth of the financial market in the country, have promulgated a set of laws and circulars to frame the Islamic

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[8] See appendix E for a comprehensive comparative table of economic data for Lebanon and other MENA countries.

[9] The 3rd Islamic Financial Services Board Summit, May 17-18, 2006, Beirut.

Financial industry within the general Lebanese banking system, its regulations and its characteristics.

The set of laws and circulars regulating the Islamic Financial industry in Lebanon are:

Reference	date issued	nature	Pertaining subject
575	*11/2/2004*	**Law**	Establishment of Islamic banks in Lebanon
94	*26/8/2004*	circular	Operations of Islamic Banks in Lebanon
95	*26/8/2004*	circular	Conditions for establishment of Islamic banks in Lebanon
96	*20/10/2004*	circular	Murabaha instrument regulations
97	*19/1/2005*	circular	Musharaka instrument regulations
98	*1/6/2005*	circular	Islamic collective investment schemes
99	*1/6/2005*	circular	Ijara and Ijara wa Tamalluk operations
100	*16/7/2005*	circular	Mudaraba instrument operations
101	*10/12/2005*	circular	Salam instrument
102	*10/12/2005*	circular	Istisna instrument

Table 2-1: Laws and circulars regulating Islamic banking operations in Lebanon, as of June 2006.

Under the present laws and regulations, we can highlight the following landmarks of the legal framework of Islamic banks in Lebanon:

- The minimum capital required is US$100Mn to establish an Islamic bank in Lebanon. A minimum of US$20Mn could be accepted, if the new institution is a member of a group backing it in guarantee for the remaining US$80Mn. This is the case of the Lebanese Islamic bank, backed by Credit Libanais.
- Each IFI (Islamic Financial Institution) is to appoint its own Sharia Board.
- A maximum of 30% of the IFI (Islamic Financial Institution) capital is allowed to be represented in fixed assets
- A minimum of 5% of the IFI capital must represent its total extra balance sheet investments.

- 12% of net investment profit should be placed in reserve until it reaches the double amount of the IFI capital, additional to the prudential reserve of 15% of total deposits at the Central Bank.
- Collaterised operations cannot exceed 60% of the value of the collaterals.
- IFI cannot finance a company belonging to its group by more then 30% of its capital, maintaining a maximum of 10% of its capital with each of its group companies.
- A minimum of 50% of the total investment portfolio of an IFI should be invested or placed in Lebanon.
- Murabaha operations are allowed and regulated.
- Mudaraba operations are allowed and regulated.
- Musharaka or equity purchase operations are allowed and regulated.
- Islamic collective investment funds operations and establishment are allowed and regulated.
- Ijara and Ijara wa Tamalluk operations are allowed and regulated.
- Istisna instrument is allowed and regulated.
- Bai al Salam instrument is allowed and regulated.
- Sukuk instruments are, to the date of this document, under study and a draft of a regulation is already under final revision by BDL legal department[10].

In general, and referring to the general mandates of the Islamic Sharia, and within its framework of Halal and Haram[11], the above mentioned laws would allow, in general the operations of equity financing and debt financing in Lebanon.

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[10] Barbour, Bernard legal department of BDL, in an interview dated 18 April 2006 with the author.

[11] Halal: allowed, Sharia compliant. Haram: prohibited, not Sharia compliant.

Islamic **equity financing** represents a component of the overall capital market activity. Typically, equity financing is structured through profit-sharing contracts or `Uqud al Ishtirak[12]. The two common types of equity financing instruments are Mudaraba (profit sharing) and Musharaka (profit and loss sharing)**.**

Significant differences, however, occur in the area of **debt financing** because conventional debt financing is essentially structured upon interest-based lending. Islamic debt financing is structured through contemporaneous underlying contracts of exchange such as sale and purchase contracts or `Uqud al-Mu'awadat[13]. There must be an underlying asset that is made the subject matter of the contract in Islamic financing as opposed to a mere debt paper in conventional financing. Common Sharia principles that are used in Islamic debt instruments include Murabaha (trade with mark up or cost plus), Ijara (lease financing), Bai` al-Salam (advance purchase), Istisna (purchase order) and others. Similarities with the conventional market also exist in Ijara, whereby Sharia recognizes the different types of leasing such as an operating lease and a finance lease, as long as the aim of the lease is Sharia compliant.

2.1.1 Lebanon landmarks: Securitization and Fiduciary laws

In commenting the 575 Islamic banking law and its circulars, we need to assess also the application of the Securitization law 705 of 9-12-2005 and the Fiduciary law 520 of 6-6-1996.

It is to note that those two laws are not specific to Islamic or conventional banking and we will explore in brief their use and application in the Islamic Financial industry only, being this the scope of this paper.

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[12] `Uqud al Ishtirak: *Trans:* Partnership Contracts.

[13] `Uqud al-Mu'awadat : *Trans:* Exchange of goods Contract

2.1.1.1 Securitization law # 705 of 9-12-2005[14]

The law defines securitization as "*the financial operation resulting from the originator's assignment of assets belonging to it, to a legal entity created for that purpose according to the provisions of this law, with or without the help of a financial intermediary".* It also defines the SPV (Special Purpose Vehicle) or Mutual fund and details its *modus opearndi* . The SPV can be either a Fund or any other legal entity, Lebanese or foreign, approved by BDL, the Central Bank of Lebanon. The law also distinguishes between Asset backed Securities (ABS) and Mortgage Backed Securities (MBS).

It is to be mentioned that securitization operations could be performed prior to the promulgation of this law, relying on law # 520 of 6-6-1996 regarding "Fiduciary contracts and the development of the capital markets" which remains enforced.

The features of this law are summarized below:

- The securitization became governed by a specific law, which is more robust then a transaction governed by a contract under law 520 of 6-6-1996 on Fiduciary contracts.
- The law solves the delicate question regarding the "True sale" of assets to the SPV by the originator.
- The law protects against "claw back risk": the transfer of assets cannot be considered void and consequently be reclaimed in case of bankruptcy.
- The SPV under this securitization law benefits from a "stand alone" nature and status in opposition to its status in the fiduciary law.
- Contrary to the Fiduciary law, the securitization law allows the transfer of movable as well as real estate assets.
- The law permits the inclusion of future cash flows and future receivables in the evaluation process.

[14] The comments included in this section are extracted from Mr. Boustany, Iad &Dr Diab, Nasri Antoine (2005),

- Since the process of securitization involves the transfer of ownership of the asset twice, once from Originator to SPV and the second time from SPV to Originator, the law authorizes the payment of 50% of the registration tax in each transaction. Hence, twice 50% is saved.

BSEC, Bemo Securitization, under the management of Mr. Iad Boustany, has benefited from the securitization law and have conducted several securitization operations that positions it at a rancking of 22nd worldwide among major players like Citigroup and Credit Suisse first Boston[15].

According to Mr. Iad Boustany and Dr. Nasri Antoine Diab[16], the law represents some drawbacks. The major drawbacks of this law are:

- The law limits the nature of the Originator (i.e. eligible sellers of assets to the fund) to physical persons or corporate entities. Hence, a Fund or a trust cannot be an Originator, limiting the market opportunity and curtailing the eminent need to reach a scale economy in this industry, to reduce the costs.
- The definition of assets allowed to be transferred excludes the de facto transfer of rights and risks of the same to the Fund, i.e. the risks related to the holding of all types of assets, movable and fixed and any obligations carried out by third parties along with the present and future cash flows.
- The law requires the setup of a third party depositor, which preempts the cost feasibility of small deals.
- The law leaves an ambiguity related to whether the Fund is subject to VAT tax or not.
- The law imposes registration fees of 6% on certain movable assets acquired. This fee burdens the cost structure of the operation

"Asset Securitization in Lebanon: a New legal Framework," *BSEC publication*.

[15] Deutche bank (2005), "Global securitization and Structured Finance", London.

[16] Idem 14

These are the major issues concerning the securitization law of Lebanon. It is clear that Islamic securitization is possible through this enacted law, as long as the operations and transaction comply to the Sharia. So what are the main principles of Islamic Securitization?

2.1.1.2 Islamic securitization

The following is a diagram of an Islamic Securitization operation[17].
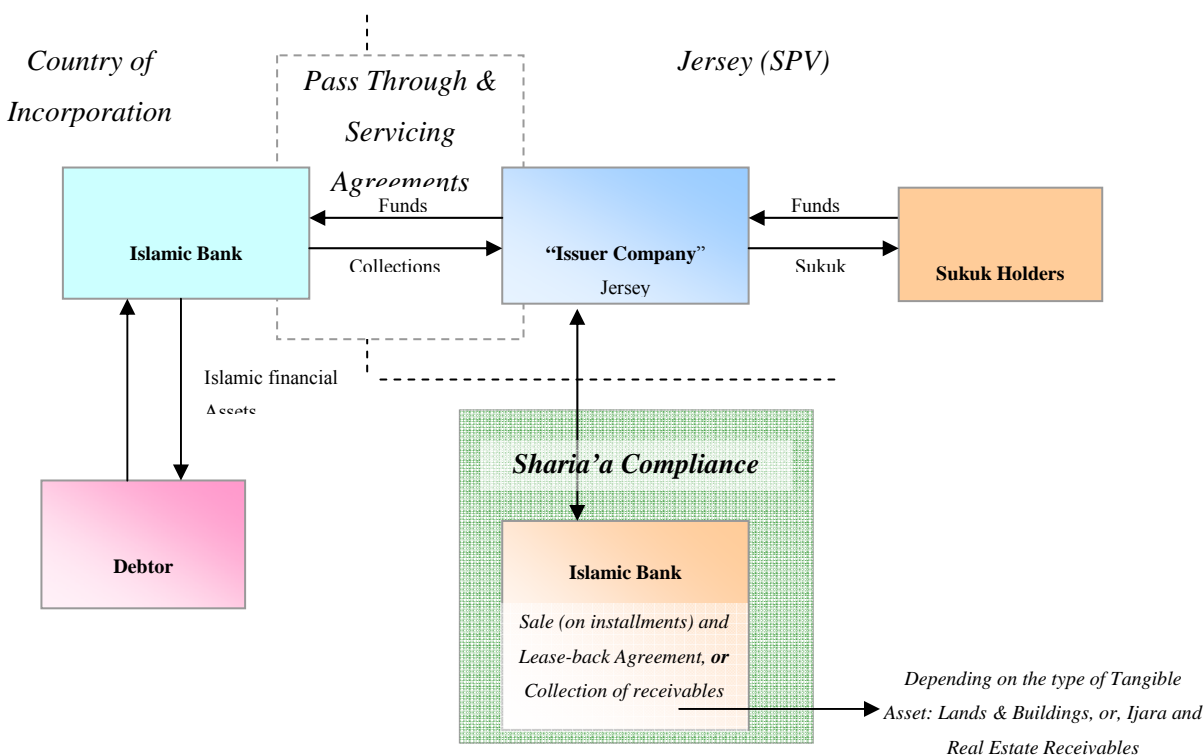
Figure 2-1 Islamic Securitization operation: Adapted from Mr. J.M.Riegel. Islamic Finance course, ESA-2005

The basic Sharia compliant considerations are:

- It is asset-backed (at least for 51% of the outstanding issue),

[17] Adapted from: Riegel, Jean - Marc (2005), "Islamic asset securitization", *séminaire en finance Islamique*, ESA, Beirut.

- It complies with the principles of Risk-Sharing under Sharia law as opposed to the principle of time value for money (Interest),
- The return on the investment will have the same form as for conventional securitizations, i.e. it will reflect the exposure for the Investors on the securitized portfolio.

The Lebanese securitization law, in spite of all its drawbacks discussed in 2.1.1.1 above, remains very application friendly. The Lebanese regulator allows the creation of offshore SPV companies and is in the process of amending the present law to include BSEC's suggestions and recommendations, as discussed earlier. The comparative matrix below illustrates the strategic of Lebanon vis-à-vis some of the GCC countries concerning securitization[18].
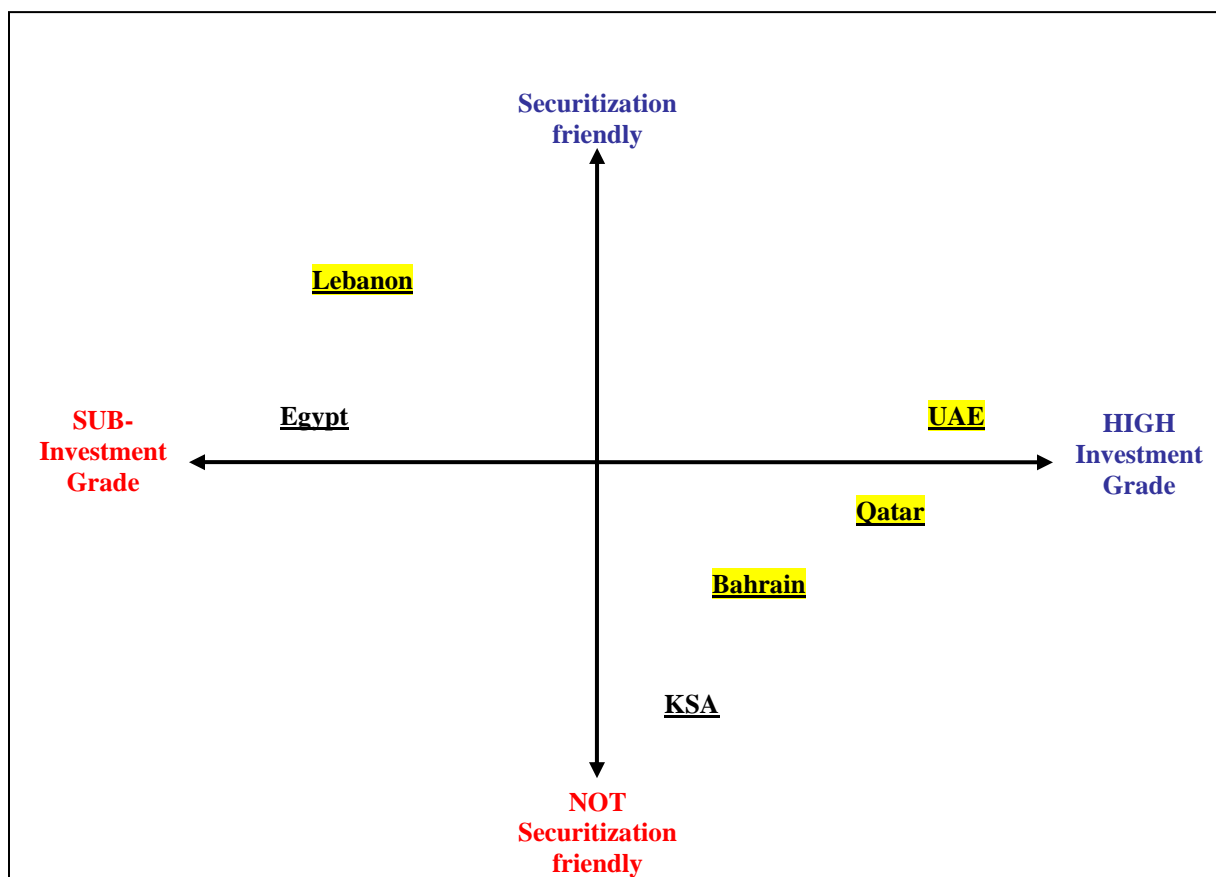
Figure 2-2 Securitization-Investment grade matrix. Selected GCC countries

[18]Source: Boustany, Iad Georges, Sleiman Roula & Sayegh Elias (2005), "Securitization in MENA/GCC: Activity overview by asset class", *BSEC Publications.*

It is clear from
Figure 2-2 above, that Lebanon can play a major role in the securitization market, and particularly in the Islamic securitization market. The issue to be addressed is the investment grade or rating of Lebanon.

2.1.1.3 Lebanese Fiduciary law # 520 of 6-6-1996

Unique in the MENA and GCC region, the Lebanese fiduciary law, promulgated in 1996, was inspired by the fiduciary laws of Luxembourg, Switzerland and Belgium[19]. This unique feature of the Lebanese financial industry, not present at all in any country in the region, has several applications in the domain of Islamic finance and Islamic securitization.

The following is a brief comment on the features of this law:

- Existing banks and authorized financial corporations can create a fiduciary trust. They are directly controlled and regulated by the central bank, BDL.
- Fiduciary contracts, the “constituent” or client and the content of the contract are covered by the Lebanese banking secrecy law of 03-09-1956.
- Can be included in a fiduciary contract: Movable goods, investments, funds, stocks and credit instruments.
- Physical persons or corporations are allowed to place their movable assets in fiduciary.
- The fiduciary client can appoint a third party for the usufruct of the fiduciary income and the fiduciary assets as such.
- Fiduciary contracts are not subject to inheritance and are not included in the inventory of goods and assets of the deceased.
- The goods and assets of a fiduciary contract are not object of guarantee for a credit. They cannot be ceased in a bankruptcy suit against the client and do not make an integral part of the client’s patrimony subject to bankruptcy or credit default laws.

Drawbacks and critics to the fiduciary law:

- No fixed assets are allowed in a fiduciary contract, which limits the use of this instrument in securitization and real estate management.
- Only physical or corporate entities can use this instrument. It is requested to extend the eligible entities to funds also.
- The use of the fiduciary trust does not exempt it from the double tax implications based on the 5% tax imposed on capital gains and interests.

2.2 Current operational status of the Islamic Financial institutions in Lebanon.

It is clear that the Islamic banking industry in Lebanon is still in its first months of existence, but the market has witnessed the creation of several Islamic banks and finance houses in the past 24 months. As of June 2006, the following are the Islamic banks and finance houses in Lebanon:

Existing Commercial Banks that will be re-listed as Islamic Banks[20]			
Name	**Effective Date of Operation**	**Capital - US$m**	**Mother company**
Al Baraka	*6/2/1979*	Will become 20	Al Baraka group-Bahrain
Arab Finance Investment House	*12/26/2002*	20	Arab Finance House Holding

Table 2-1 Existing Commercial banks in Lebanon that will be re-listed as Islamic Banks, as of June 2006.

List of Islamic Banks in Lebanon

[19] Mr. Barbour, Bernard, BDL. Interview with the author. See appendix C for more details.

[20] Table 2-1 and Table 2-1 by Miss Joelle Gemayel, Banque du Liban.

Name	Date of Approval	Effective Date of Operation	Capital-US$m	Mother company
Lebanese Islamic Bank	*10/20/2004*	*7/1/2005*	20	Credit Libanais
BLOM Development Bank	*8/17/2005*	*Not yet*	20	BLOM

Table 2-2 List of approved Islamic banks in Lebanon, as of June 2006.

It is clear from Table 2-1 and Table 2-2 that Islamic banks in Lebanon are in their first operational steps, save Al-Baraka Bank who started operating in 1979 under a private scheme of Islamic Sharia compliance but under the umbrella of the laws of the BDL in application.

The following tables depict the financial highlights of the Islamic industry in Lebanon[21] , and a compilation of modes of finance in Lebanon. The sources of these data are the Lebanese Central Bank and some financial data diffused by these institutions on their websites. Please note that no data is available prior to 2005.

We could not assess the provenance of the deposits. It is important for us in this study to determine whether the investors are Lebanese or non-Lebanese. It is clear for us at this stage that the development of the Islamic financial industry in Lebanon will have to explore at least two sources of funds: Lebanese funds and foreign funds. The mechanism of attraction and modes of finance for each category is *sui generis* in the sense that the demand drivers are not the same and the horizons and expected returns are not similar either.

N.B. Table 2-3 and Table 2-4 **that** ***follow are unofficial and compiled by the author from un-audited financial statements of some of the banks and IFI's operating in Lebanon. They should be subject to revision when data is publicly available.***

Lebanon- IFIs Financial Highlights-2005 (US$ Million)

[21] For a comprehensive financial ratio analysis, please see section 3.7, Lebanon-GCC comparative study.

	2005
Paid-up Capital	47
Total Assets	194
Cash & Cash Equivalents	65
Contra Accounts	9
Total Investments and Financings	89
Total Deposits	102
Current Account and Savings	17
Restricted Investment Accounts	7
Unrestricted Investment Accounts	79
Reserves	15
Net Profit	1,2

Table 2-3 Islamic Financial institutions in Lebanon- financial Highlights. (Approximate and unofficial data)

The performance of the newborn Islamic banks in Lebanon will be analyzed in a comparative study suggested in section 3.7. However we wish to state that the capitalization level of the Lebanese IFIs is quite high per institution compared to GCC countries' IFIs as will be shown in the comparative study. Please note that the investment/capital paid is almost 2, which is a low ratio of investment. Nevertheless, the operations of the IFIs in Lebanon are promising and this ratio is expected to grow to match the level of the GCC countries IFIs.

Modes of Islamic finance-Lebanon. (US$ Million)		
Mode Of Finance	**2005**	**% of total**
Murabaha	58	*73%*
Musharaka	15	*19%*
Mudaraba	0.5	*1%*
Leasing	1	*1%*
Istisna	5	*6%*
Salam	0	*0%*
Others (specify) Real Estate	0	*0%*
Total	80	*100%*

Table 2-4 Islamic Modes of financing in Lebanon-2005. (Approximate and unofficial data)

It is very notable the percentage of Musharaka in the Lebanese IFIs modes of finance. As an example, we cite that in the UAE and in Qatar, Musharaka is virtually non-existing, while in

Bahrain it represents a shy 3% of the total modes of finance[22]. Istisna instrument participation is also notorious in Lebanon compared to its GCC peers, still the most common and used mode of finance in Lebanon and its GCC peers remains the Murabaha (cost plus) instrument, with 73% of total volume of investment in the Islamic banking sector of Lebanon.

2.3 Evaluation of the actual status of the Islamic Finance Industry in Lebanon.

2.3.1 Methodology

The methodology used to tap the real attitude of the main Islamic industry players in Lebanon was “In depth open and semi-open questions interviews”. Thirty-six (36) direct interviews were conducted, seven (7) of which are confidential and the interviewees asked not to be quoted[23].

Name	Institution	Title	Date
H.E. Dr Ahmed Jachi	**BDL**	*Vice Governor*	*06/04/2006*
H.E. Mr. Yacoub Sarraf		*Minister of environment*	*22/04/2006*
H.E. Dr. Elias Saba		*Former Finance Minister*	*17/04/2006*
Abdul Ghani Datuk Zamani	**Bank Negara Malaysia**	*Deputy governor*	*18/05/2006*
Dr Francois Bassil	**Byblos Bank**	*Chairman*	*05/05/2006*
Mr. Salah Jaidah	**Qatar Islamic Bank**	*CEO*	*19/05/2006*
H.E. Mr. Adnan Kassar	**Fransabank**	*CEO*	*10/05/2006*
Dr Jamil Jaroudi	**Arab finance house**	*DGM*	*06/04/2006*
Mr. Khaled Temsah	**Lebanese Islamic Bank**	*CEO*	*28/04/2006*
Mr. Mohammed Al-Omar	**Kuwait Finance House**	*Deputy G.M.*	*19/05/2006*
Mr. Saad Jamaleddine	**Arab Finance House**	*Senior executive manager*	*02/05/2006*
Mr. Bernard Barbour	**BDL**	*Legal department*	*18/04/2006*

[22] Please refer to section 3.3 of this study and table 3-2 GCC modes of finance.

[23] Please see appendix C for a comprehensive list of interviews, dates and subjects discussed.

Sheikh Dr Khaled Faqih	**Arab finance house**		*19/04/2006*
Mr. Sidiqi el Zein	**Qatar Islamic Bank**	*Communication officer*	*18/05/2006*
Rohana Yusuf	**High Court, Malaysia**	*Judicial commissioner*	*18/05/2006*
Dr Fadi Gemayel	**Ministry of Industry**	*Consultant*	*18/04/2006*
Dr Joe Sarrou	**Fransabank**	*Investment banking*	*10/05/2006*
Mr. Nabil Chaya	**Audi Saradar bank**	*Capital market*	*20/04/2006*
Mr. Walid Abdulla Rashdan	**Kuwait Finance House**	*Executive manager*	*19/05/2006*
Mr. Iyad Boustany	**Bsec-BEMO**	*G.M.*	*01/06/2006*
Mr. Nassib Ghobril	**Byblos Bank**	*Head of research*	*03/05/2006*
Mr. Talal Kaisi	**Al Baraka bank Lebanon**	*Branches manager*	*05/06/2006*
Sheikh Bilal alMulla	**Al Baraka bank Lebanon**	*Sharia Internal controller*	*05/06/2006*
Mr. Anouar Hassoune	**Standard and Poors-France**	*Director*	*19/05/2006*
Prof. Simon Archer	**University of Surrey**		*18/05/2006*
Mr. Hiro Tsubota	**The world bank**	*Regional financial officer*	*18/05/2006*
Mr. Ahmed Barghout	**Al Multaqa**	*Founder*	*19/04/2006*
Miss Lina Tayyara	**Kroll international**	*Risk manager*	*24/04/2006*

Table 2-5 List of interviews conducted for the purpose of this study.

From this fact finding activity, a myriad of ideas was collected. Still, Lebanon is not yet experiencing a “gold rush” phenomena on this new industry that is already regulated. This dilemma touches the very essence of this paper, and it is of great importance to touch the heart of the problem, from a qualitative perspective, to say the least. H.E. Dr Ahmed Jachi, vice Governor of BDL (Banque du Liban, Lebanon Central Bank), made it very clear on our first interview: *“In the light of law 575 of 11-02-2004 and its circulars and bylaws, where does Lebanon stand vis-à-vis the GCC and MENA region, in the Islamic Financial industry?”*.

It is true, Lebanon cannot match the level of abundance and liquidity that the petroleum industry provides, nor can it boast a GDP or per capita income matching those of our neighboring countries, yet, can it be an attractive hub for the Islamic financial industry? Can Lebanon attract

those investors? What can Lebanon offer? What is the real problem, if any at all, impeding the newborn financial industry to boom and add value to the national economy?

In fact, one can attempt to answer these questions from the point of view of the industry initiators, i.e. the Islamic financial institutions. The fact remains that the investors' attitudes and opinions were taken into consideration as well, and the results of this investigation are summarized in the following section.

2.3.2 Comments and criticism of the actual regulations

a- The law links the Unrestricted Accounts deposits' revenues to the overall IFI's performance revenues. This fact creates several restrictions to the investors as well as to the IFIs. For instance, investors could expect remunerations to their unrestricted accounts once a year only, and some of the investors interviewed showed some inconformity with this issue. Many of the investors interviewed would wish to collect their revenues at least twice a year and the majority insists on receiving quarterly revenues. We believe that this issue is to the detriment of attracting depositors to the Lebanese Islamic banking system. The IFI's management sees in this linkage a virtual partnership of the depositor in the equity of the bank. They believe revenues to the Unrestricted Accounts depositors should be linked to the performance of the investments where those revenues were committed and not to the whole bank's performance.

b- The law 575, article 3, requires the investment deposits maturity to be of a minimum of six (6) months. This limitation is double fold:

i. The average short-term deposit in Lebanese banks is 2 months, and it represents 45% of deposits. Hence, this limitation prevents IFIs in Lebanon to tap the most important short-term deposit transactions in the Lebanese market.

ii. Investors prefer the versatility of a short-term deposits. This limitation reduces the acceptance of IFIs by investors as holistic portfolio managers. In other

words, investors at large would prefer to manage their portfolio in one bank. One month and three months deposits should be authorized in IFIs in Lebanon.

c- The operation of IJARA Muntahia bi Tamlik, under the current tributary and tax law of the Republic of Lebanon, toils under double stamping. In fact, the IFI acquires the possession of the real asset subject of the operation, and as per the law, is subject to 3% stamp tax. Later, when the IFI transfers this asset to the end user, as per the contract, another 3% stamp tax is applied. This 6% taxation burdens the competitive edge of the IFIs and does not encourage the end user to opt for such an alternative Sharia compliant way to acquire an asset with differed payment. It is worth mentioning that the UK and the Hashemite Kingdom of Jordan enacted a law to circumvent this handicap for the instrument of Ijara Muntahia bi Tamlik. The end user pays the stamp tax only once. The issue of double taxation affects also the transfer of assets in a securitization operation. It is noted that the government has authorized a levy of 50% on the transfer tax in case of securitization. However, it is necessary to consider that a securitization process does not really involve the sale or transfer of usufruct of the asset, but its is , in its essence, a financial instrument related to liabilities and receivables in a corporation: Securitization is a tool to finance, refinance or restructure a mismatch of liquidity gaps rather then a commercial sale of assets between two parties.

d- Stamp duty in Lebanon on each contract is set at 3‰. All the instruments and operations of an Islamic bank require at least one contract to be signed by both parties. This is mandatory by Sharia. Some Islamic financial operations would require more then one contract; hence, the 3‰ contract stamp tax will affect every contract. This needs to be addressed by the government of Lebanon. It is clear that the taxation law of the country does not favor the practical operations of an Islamic bank instruments and products.

e- Murabaha contracts involve the purchase of a real asset by the bank, its resale to the client with a markup and subsequent deferred payments by the client. VAT (value added Tax) in Lebanon is 10% over invoiced value. The IFI is incurring in payment of 10% VAT over the cost price of the asset and later is collecting 10% VAT from the client over the final (cost + markup) price of the same. The client is paying an extra VAT over the markup value of the bank. This over cost can be substantial and is a competitive barrier that the conventional bank enjoys over an Islamic bank, since the former is not involved in a purchase-sale operation. As a numerical example, if the Islamic bank marks up his Murabaha with 15% the end user is paying an extra 0.1 x 0.15= 1.5% extra cost representing the VAT on the banks profit that is transferred to the client through the invoice. This spread of 1.5% in comparison with an equivalent conventional bank credit for purchase of goods is preemptive to the Islamic industry. Actually, the IFIs in Lebanon are opting for a WAKALA agreement between the bank and the client, where the Islamic bank delegates to the client the right to buy the good directly on his name to avoid the 1.5% VAT extra cost. For some Sharia scholars this operation is not permitted since the bank does not enter in possession of the real asset and hence is not bearing the risk of its possession. This is considered a JAHALA or Gharar.

f- Fifty percent (50%) of the assets of a bank should be in investments in Lebanon. If the bank owns a real asset through these investments, he has 6 months to liquidate. BDL is actually pushing the IFIs in Lebanon to direct their investments to Murabaha and Istisna, where the property transfer of the real asset is done when the contract(s) is (are) signed. This is, in our view, a social dimension of the law in discussion; yet, a comment should be forwarded in the sense that the major investment volumes in Lebanon are in real estate. It looks quite implausible that an IFI acquires a real estate asset with the limitation of having to liquidate it in 6 months.

g- The law request the IFIs to liquidate any assets resulting from an investment project or Musharaka after a maximum period of 25years. The rationale behind this measure is to

force the IFIs to remain liquid and not to be transformed into real assets brokers or managers.

h- The government of Lebanon subsidizes the INTEREST payments due on loans and credit advanced by conventional banks on Housing and Agricultural, Touristic and Industrial projects. The subsidy amount can reach up to 90% of the total amount of interests in some specific cases. IFIs clients do not benefit from this subsidy since the Ijara Muntahia bi Tamlik or Murabaha instruments used for Islamic housing loans, for example, do not bear interests but revenues rather. The subsidy covers only interests and therefore Islamic housing loans and instruments do not benefit from this subsidy. As an example, a house costing $100,000 will be financed at 8% for 10 years[24] in a conventional bank, including the subsidy of the government. If in Ijara Muntahia Bi Tamlik for the same period, it will cost also 8%, to maintain the competitive benchmark. However, the IFI makes less profit then the conventional bank on a similar deal given the extra costs of double stamps and contracts involved.

i- All banks in Lebanon, including the Islamic Banks are required to deposit at the central bank a reserve of 15% of their weekly average volume of deposits accounts. The central bank remunerates these reserve deposits with an interest that the Islamic banks will not use, as per the Sharia principle of not using interest. These revenues, while engrossing the profits of the conventional banks are donated to charity by Islamic banks. The central bank (BDL) has to consider remunerating the Islamic banks reserve deposit according to Sharia, investing these reserve deposits in an Islamic Sharia instrument so that the revenues will be accepted by the Islamic banks.

j- The law considers Mudarabah deposits like current deposits. As such, they are subject to 15% reserve deposit at the central bank. The Mudaraba accounts are, in contrast,

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[24] The housing loans in Lebanon are actually financed with either a fixed interest rate, which is today at 8% or Libor +2% variable rate. The subsidy is of 2-3% on interests paid, as a supportive policy from the government.

considered as Equity by the IFI and they believe they should not be subject to reserve deposit.

k- The capital of the Islamic bank, at times up to US$100,000,000 is deposited at the central bank without any remuneration. This unproductive frozen capital increases the stress over the revenues of the Islamic bank, obliging it to venture in operations maximizing the profit of all portfolios to cater for this 0% non-productive deposit. The Central Bank is asked to come up an alternative scheme of interest on deposits to remunerate this capital and relieving some of the stress off the shoulders of the IFIs shareholders.

l- The Central bank is also the creditor of last resort to the banking institutions of the country. Liquidity needs for short periods are answered by overnight advances inter-banks and from the central bank as a last resort. The IFIs cannot use this facility since those cash advances are remunerated with an overnight interest rate that the IFIs cannot accept to pay. The IFIs in Lebanon are left with no other alternatives but to remedy their cash needs by selling commodities to a peer bank in a Murabaha operation, with all the limitations of producing up to four contracts to ensure the Sharia legal aspect of the same. In fact, IFIs in Lebanon do not use this operation for short periods of liquidity needs.

m- The regulator should allow funds to be eligible sellers of assets to other funds both in case of securitization and fund establishment. A fund should be able to securitize part or all his assets, and a fund should be allowed to form a fund of funds as well.

n- Moreover, the regulator should define specifically the transfer of risks and rights of assets transferred to funds. This will ensure a solid understanding of both parties, in a securitization process, of the rights and responsibility of each in case of a conflict.

o- Consider the elimination of the third party "Depositor" of securitized funds, in the special case of small amounts involved. We understand, however, that the regulator has imposed this condition to ensure total transparency and to guarantee the user of this instrument of the least possible occurrence of "moral hazards". Yet, due to the elevated cost involved in

establishing the intervention of this third party “Depositors”, the overall cost can be preemptive.

p- The regulator should allow Fixed assets to be included in a fiduciary contract. It is of a paramount importance to note that the majority of foreign investors’ portfolios include real estate as a major part of their total investment. Including fixed assets in the list of allowed assets in a fiduciary contract would increase the volume of operations in this instrument.

2.3.3 Proposed solutions

a- Amend the regulation on Unrestricted deposits account to remunerate them from the results of the revenues of the portfolios they were invested in and not from the entire bank operation.

b- Amend the regulation to authorize the IFIs to receive short-term deposits of less then 6 months. We believe the short-term deposits for IFIs should be of the same nature and maturity as those in the conventional banking sector.

c- Replicate the laws adopted in Jordan and in the UK for operations involving the transient possession of an IFI of an asset, abolishing the double stamp taxation, applying the stamp tax one only on the final end user and owner.

d- Consider an exemption of multi-taxation on multiple Islamic contracts when they pertain to one single transaction and operation.

e- Allow the IFIs to be exempt from VAT when acquiring an asset that is bound to be transferred to its end user and owner at the maturity of the contract, saving the client an extra 1.5% over the total amount of invoice in a Murabaha contract for example. This VAT exemption should be exclusively applied to the final object of an operation.

f- Liberate the constraint of liquidating 50% of the real assets within months only. The door should be open to the IFIs to compete on equal basis with conventional banks.

g- Amend the law subsidizing the interest payment for housing loans by conventional banks to include “the revenues on housing operations by Islamic institutions”.

h- The Central bank should remunerate the reserve deposits of the IFIs by a revolving Murabaha operation so that those revenues could be accepted by IFIs.

i- The law should be amended to exempt the Mudaraba accounts from the 15% reserve caution, and consider these deposits as part of the equity of the IFIs[25].

j- Design a “last resort cash advance” mechanism to include the IFIs as possible users. In fact the Pakistan council of Islamic Ideology proposed back in 1980 a Profit sharing mechanism where this profit (remunerating the central bank cash advances) can be determined on a daily revenue basis[26]. Another solution would be to establish a “common pool fund” by IFIs in Lebanon under the supervision of the BDL to extend, under a cooperative basis, overnight cash advances to an Islamic bank in short of Liquidity.

k- The BDL and the Lebanese courts should ensure compliance with Sharia principles when dealing with litigations. Malaysia has opted for a similar arrangement, dealing with the “Law of the Land” in case of Islamic Finance related litigations and arbitrage[27].

l- BDL and the Lebanese legislator body should consider the introduction of a Sukuk law and Takaful law, to complement the Islamic Financial instruments in the Lebanese marketplace. The Sukuk issue will be dealt with in details in the next chapter.

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[25] The proposal of imposing the cash reserve requirement only on demand deposits has been put forth by Chapra who is in favor of the fractional reserve system but wants to exempt *Mudaraba* deposits from this requirement. (Chapra, 1985, pp197-991). Putting cash reserve requirements only on demand deposits is justified by him on the grounds that *Mudaraba* deposits (or investment deposits in the terminology of Islamic banks) are held in the form of equities. Since other forms of equities are not subjected to cash reserve requirement, there is no justification for *Mudaraba* deposits being subjected to such a condition.

[26]Munawar, Iqbal & Ausaf, Ahmad & Tariqullah, Khan (1998), “Challenges Facing Islamic Banking”, paper *nº1*, *Islamic Development bank Islamic Research and Training Institute.*p.36.

[27] Judge Yusuf, Rohana (2006), High Court Malaysia, “Islamic banking and finance in Malaysia: The legal framework”, IFSB Beirut.

Chapter 3

Islamic Financial industry in the GCC region: A brief overview.

3.1 Introduction

The 9-11 events created a shift in the behavior of the investors of the oil rich countries. It became risky to deposit Arab funds in the US banks due to the antiterrorism law that can unjustly confound an Islamic fund or investor with terrorism financing, risking the freezing of the account. The demand for Sharia compliant investment opportunities has pushed many western financial institutions to establish either an Islamic window or an Islamic full fledge banks in the area. The surge of the Bahrain Financial Hub is a witness to the attractive niche of Islamic financial investments in the region.

3.2 Scope of the study

In order to assess the potentiality of Lebanon as a financial hub for Islamic investment we will evaluate the Islamic financial industry in three countries considered today as Islamic Financial hubs:

1- Bahrain

2- Qatar

3- UAE. (United Arab Emirates).

We will also focus on some other markets as well, namely Sudan, Kuwait and The KSA (Kingdom of Saudi Arabia), in some special areas like Salam, Istisna and real estate Sukuk al Ijara. An overview of the industry in the GCC countries will give us a comparative outlook upon which we will base our recommendations and views concerning the Lebanese Islamic Financial industry. The GCC statistical and financial data section will head the subsections on the countries study.

The study is a comparative one, intended primarily to detect and assess Lebanon's possible niche of penetration in the industry, rather than a quantitative economic and financial evaluation of the countries in question.

3.3 The GCC Islamic finance Industry. Statistics and figures.

3.3.1 GCC financial highlights

In the year 2002, a US$3.2Bn constitute the paid capital of the Islamic banks and institutions operating in the GCC countries.

The total deposits, excluding the Restricted Investment accounts add up to US$54.1Bn in 2002, backed up by a total of US$2.35Bn in reserves, representing 4.3% of the total deposits.

The total investments reached US$35.5 Bn, of which 58% represent investment in real estate. (See Table 3-2, modes finance in the GCC). It is notable mentionning that the total investments volume represents 11 folds the paid-up capitals of the GCC Islamic financial institutions, and one fold the total deposit.

Financial Highlights (for the years 2000-2002 (US$ Million)- GCC			
	2000	**2001**	**2002**
Paid-up Capital	2,990	3,205	3,214
Total Assets	29,895	35,992	41,630
Cash & Cash Equivalents	1,873	4,067	4,662
Contra Accounts	3,968	3,301	2,982
Total Investments and Financings	25,689	29,205	35,512
Total Deposits	22,438	27,753	32,716
Current Account and Savings	1,109	2,231	3,100
Restricted Investment Accounts	484	372	398
Unrestricted Investment Accounts	10,741	13,231	15,338
Reserves	1,528	2,146	2,352
Net Profit	833	792	829

Table 3-1 GCC financial highlights. Source: Islamic Finance Directory 2004.

The GCC countries modes of finance include all Sharia compliant instruments as shown in the table below.

We will consider first the total amount of modes of finance in the area and later we will compare horizontally to analyze the modes of finance of Bahrain, Qatar and the UAE.

Mode Of Finance- GCC	2001 (US$ Million)	2002(US$ Million)	% of tot.2002
Murabaha	8,687	9,692	***32%***
Musharaka	68	84	***0%***
Mudaraba	342	395	***1%***
Leasing	634	1,190	***4%***
Istisna	1,620	1,425	***5%***
Salam	64	7	***0.02%***
Others (specify) Real Estate	16,168	17,558	***58%***
Total	27,583	30,352	***100%***

Table 3-2 GCC Modes of finance. Source: Islamic Finance Directory 2004.
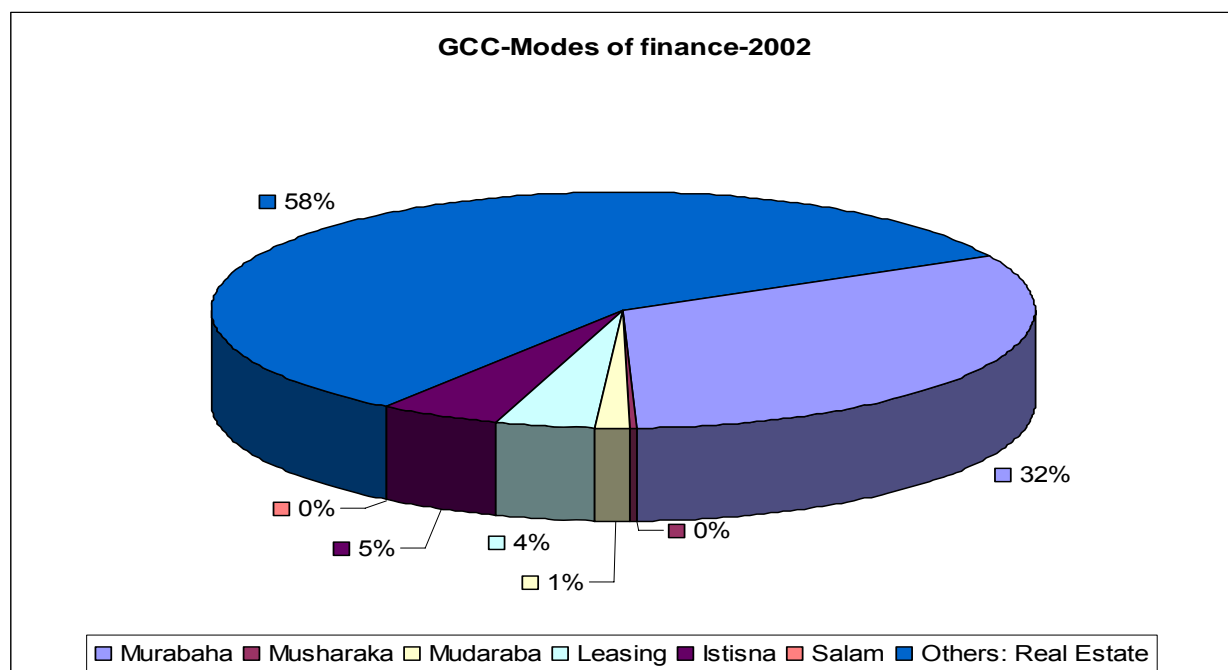
Figure 3-1 GCC modes of finance- 2002

It is noted that 90% of all modes of finance in the GCC are of Murabaha and Real estate. The volume of the Istisna and Musharaka are much reduced representing 5% of the total. We think that the Islamic banking operations in the GCC are of commerce, buy and sell, rather then the

social development of infrastructure and new companies and industries using a PLS scheme. The Salam mode of finance, primarily focused on agricultural commodities, is virtually non existing because of the meager agricultural output of this area of the globe.

On a side note, among the modes of finance in Sudan, a primarily agricultural society, Salam operations represent a substantial 6% of the total and Musharaka another 24% , with the real estate sector as low as 22%, as shown below.

Mode Of Finance – SUDAN (US$ Million)	2001	2002	% of tot.2002
Murabaha	125	150	***40%***
Musharaka	84	87	***24%***
Mudaraba	21	33	***9%***
Leasing	0	1	***0%***
Istisna	0	1	***0%***
Salam	19	20	***5.53%***
Others (specify) Real Estate	51	80	***22%***
TOT:	300	372	***100%***

Table 3-3 Modes of finance in Sudan. Source Islamic Finance directory 2004.

It is interesting to explore the financial highlights of the Islamic banking sector in the GCC by country. This will shed a light on the various variables involved and would help identify penetration strategies for Lebanon.

It is apparent from the Table 3-4 below and its related graph that the amount of reserves per country affects drastically the volume of financed investments.

The laws and regulations of each country in question directly modulate the data in Table 3-4. In fact, a major strategic leverage effect on any Islamic banking industry is definitely the laws and regulations affecting it. It is the focus of this paper to be able to assess the strategic strengths and weaknesses of the Lebanese laws and regulations affecting its Islamic banking industry. This endeavor will rely on the comparative methodology followed in this paper. We would like to note that the volume of the Islamic Financial and banking sector on the GCC is not overwhelmingly big, compared with the volume of the deposits of the Lebanese conventioal banks amounting to US$60Bn. One would have the preconceived opinion that the level of the Islamic banking is bigger then depicted in the tables below. This observation enhances the

prospect of Lebanon becoming a part of this “Islamic Banking major league”, and Lebanon’s competitive edge, analyzed fully in the next chapter will prove this point.

Financial highlights -2002-GCC banks- (US$ Million)					
	Bahrain	Qatar	UAE	KSA	Kuwait
Paid-up Capital	718	124	644	760	969
Total Assets	3,051	2,411	644	17,281	10,378
Total Investment	2,499	2,184	7,503	14,101	6,226
Total Deposits	3,845	1,981	7,114	13,700	7,715
Reserves	174	69	203	1,264	643
Net Profit	83	44	79	394	229
% reserve[28]	5%	3%	3%	9%	8%
%Inv+assets-cap/Dep	126%	226%	105%	224%	203%

Table 3-4 Comparative table of some GCC countries’ Islamic Banks financial highlights. Source: Islamic Finance Directory, 2004.
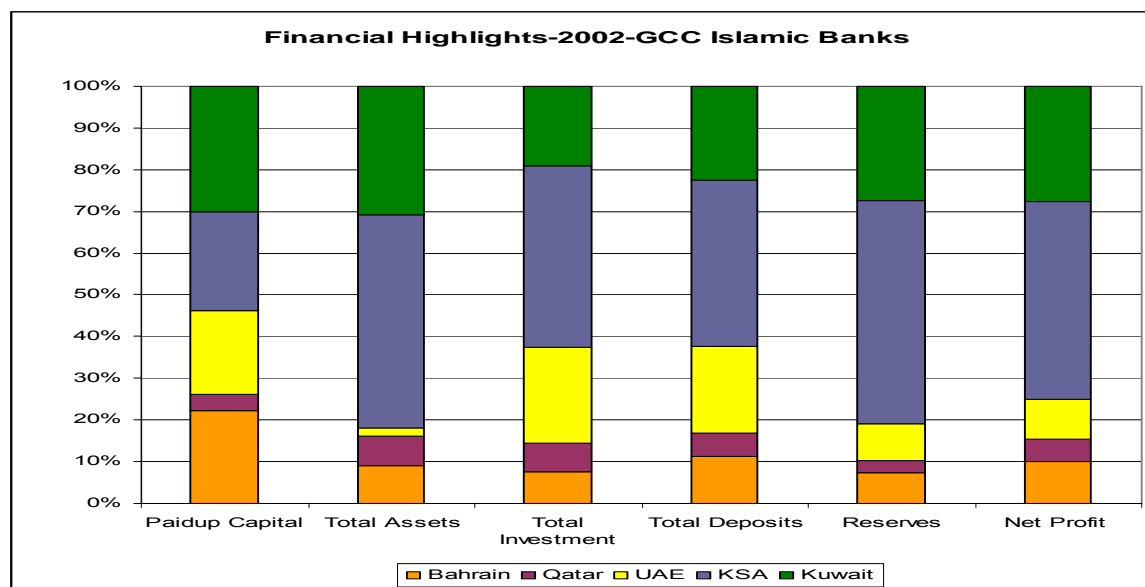
Figure 3-2 GCC Islamic Banks financial highlights-2002

[28] The reserves are computed from this table as the division of Total reserves over total deposits. They do not necessarily reflect the legal reserve percentage required by the law of each respective country.

GCC rating and Sukuk activities

The sovereign rating is onene very important factor modulating the investors' decision to invest in any country. Referring to Appendix E, the rating of most of the GCC countries is on the A1 or A2 level, save Bahrain with a rating of Baa1. The table below summarizes the rating list By Moody's:

2005	UAE	Qatar	Kuwait	KSA	Bahrain	Oman	Egypt	Morocco	Jordan	Lebanon
Moody's Rating	A1	A1	A2	A3	Baa1	Baa1	Ba1	Ba1	Ba2	B3

Table 3-5 Moody's Rating of some GCC and MENA Countries. 2005

All non-oil based economies in the MENA region have a poor rating. The sovereign rating bestows considerable importance on issuing sovereign and non-sovereign Sukuks and on cross border financial operations, like securitization and cross border Musharaka.

The table 3-6 shows some of the most important transactions in various markets where Islamic financial industry is prosperous; the relationship with the rating of the respective country is obvious.

Table 3-7 summarizes some notable deals in Sukuk issuance in the Middle East for 2003-2005. The latest of which was a US$3.5Bn for the Dubai PCFC as convertible bonds structure, Sukuk al Istismar. This structure offers the investor the option to convert his investment into equity at maturity.

The rating of Lebanon is at a low standing of B3. It is at the detriment of attracting GCC investors' funds to its financial system. *"Lebanon's sovereign rating caps all our possible operations in Lebanon and we believe that the sovereign risk of Lebanon is substantially high. We would consider this issue, as we have in fact done, when taking any investment decision in our portfolio. Other countries in the area offer the same facilities as Lebanon, but with a superior rating that is confidently risk mitigating, to a certain extent"* says Mr. Mohamed Suleiman al Omar, DGM of Kuwait Finance House[29].

[29] Interview by the author with Mr. Mohamed Suleiman al Omar, DGM of Kuwait Finance House, 3rd IFSB summit, Beirut, 2006.

Islamic Capital Markets - 06-2005						
Issuer	**Country**	**Issue Date**	**Amount**	**Maturity (year)**	**Type**	**Manager(s)**
Sovereign						
Government of Bahrain	Bahrain	Feb-05	BHD 30 Mil	5	*Ijara' (leasing)*	Bahrain Monetary Agency
Government of Pakistan	Pakistan	Jan-05	USD 600 Mil	5	*Ijara' (leasing)*	Citigroup, HSBC Amanah
Supranational						
Islamic Development Bank	Supranational organization	Jun-05	USD 500 Mil	5	*Sukuk*	HSBC Amanah, Deustche Bank, CIMB, Dubai Islamic Bank
The World Bank	Supranational organization	Apr-05	Myr 760 Mil	5	*Bai' Bithaman Ajil (BBA) (Deferred-Payment Sale)*	CIMB, ABN AMRO Bank Bhd
Corporate						
PLUS Expressways Bhd	Malaysia	Jun-05	Myr 2,410 Mil	11- 14	*Bai' Bithaman Ajil (BBA) (Deferred-Payment Sale)*	CIMB
Jimah Energy Ventures	Malaysia	May-05	Myr 405 Mil	6 - 16.5	*Istisna' (Purchase Order)*	Ammercchant Bank Berhad, RHB Sakura Merchant Bhd, MIMB
Commercial Real Estate Company	Kuwait	May-05	USD 100 Mil	5	*Ijara' (leasing)*	Kuwait Finance House, Liquidity Management Center
Time Engineering (Musyarakah One Capital Bhd)	Malaysia	Apr-05	Myr 566.55 Mil	5	*Musharika' (Profit and Loss Sharing*	CIMB
Durrat Sukuk Company	Bahrain	Jan-05	USD 152.5 Mil	5	*Istisna' and Ijara sukuk*	Kuwait Finance House
source: Iqbal and Tsubota, The Euromoney Debt Capital Markets Handbook 2006						

Table 3-6 Examples of transactions in various markets is the first half of 2005.

Notable Deals in the Middle East (2003-2005)							
Name	**Durrat al - Bahrain**	**Rep. Of Pakistan**	**Dubai MCE**	**Emirates Airlines**	**Islamic Development Bank**	**Amlak Finance**	**Dubai PCFC**
Structure	Sukuk al-Ijara	Sukuk al-Ijara	Sukuk al-Musharaka	Sukuk al-Ijara	Sukuk al-Istismar	Sukuk al-Istismar	Sukuk al-Istismar (convertible)
Size (US$mn)	$152.50	$600	$200	$550	$500	$250	$3,500
Tenor (years)	5	5	5	7	5	5	2
Country	Bahrain	Pakistan	UAE	UAE	Saudi Arabia	UAE	UAE
Sukuk Format	Reg S	Reg S	Reg S	Reg S	Reg S	Reg S	Reg S
Listed/Rated	Listed	Listed & Rated	Listed	Listed	Listed & Rated	Listed	Listed
source: ABN AMRO							

Table 3-7 Notable Sukuk deals in the Middle East. 2003-2005.

Islamic Financial industry in the GCC is booming. It is growing at a pace of 15%-20%, with emergence of new instruments' applications such as Sukuk and capital market. It is apparent that the market volume will grow more in this direction, opening to investors and institutions alike fruitful outlook into a substantial multimillion dollars market, not anymore confined to Murabaha and Mudaraba operations. This gearshift is making of Bahrain in particular, an advanced center of big Islamic Financial deals.

3.3.2 GCC Funds activities

The excess of cash liquidity in the Islamic world in particular is finding new channels of Sharia investment sources. One important instrument used is the Islamic Funds. The Islamic funds in general are very similar in structure to the Conventional funds with the pre-condition that all assets included in the fund should be Sharia compliant. These Sharia conditions are:

1. Exclude companies or stock undergoing any Haram activity: Pork, alcohol, pornography, insurance, tobacco, gaming or gambling and armament.

2. Exclude companies if Total Debt divided by Trailing 12-Month Average Market Capitalization is greater than or equal to 33%. (Note: Total Debt = Short-Term Debt + Current Portion of Long-Term Debt + Long-Term Debt).

3. Exclude companies if the sum of Cash and Interest Bearing Securities divided by Trailing 12-Month Average Market Capitalization is greater than or equal to 33%.

4. Exclude companies if Accounts Receivables divided by Total Assets is greater than or equal to 45%. (Note: Accounts Receivables = Current Receivables + Long-Term Receivables).

Currently there are more then 100 Islamic equity funds[30] and the market size is estimated at US$3.3bn over the last ten years[31].

Many major US and European fund managers are active in the field, including AXA, Brown brothers Herriman, Citibank, Commerzbank, Deutche bank, HSBC, Merill Lynch, Permal, Pictet and Cie, UBS and Wellington management to name a few. The Islamic funds existing today are diversified geographically and by activity. The funds categories and locations are summarized in the non-exclusive list below to illustrate our point:

- Global Equity (Al Dar World Equities)
- Asian Equity (Mendaki Global)
- US Equity (Alfanar US Capital Growth)
- European Equity (Al-Sukhoor European Equity)
- Emerging Market (Ibn Majid Emerging Markets)
- Single Country (RHB Mudharabah)
- Small Company (TII Small Cap)
- Technology (Alfanar Technology)
- Capital Guaranteed (Al-Ahli Global Equity Secured)

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[30] See appendix G for a complete list of Islamic equity funds. Source www.failaka.com

[31] Al Rifai, Tariq (2003), "An overview of Islamic finance and the growth of Islamic funds", *The Islamic Funds world conference.*

- Balanced/Hedge/Hybrid (Al-Rajhi/Alfanar/Al-Hilal) .

It is very important to note that the creation, development and growth of the Islamic equity funds are directly related to the essence of the Islamic Fiqh al Muamalat (Islamic commercial jurisprudence or the rules of transacting in a Sharia compliant manner).The Sharia scholars have ruled as permissible (HALAL) the investment in purified and screened stocks. This issue has modulated the Islamic funds portfolio to have a higher technology gearing, eliminating speculation and hedging techniques.

The Islamic funds offer the following advantages to the investors:

- Long-term benefits of equities vs. other asset classes.
- Risk/return relationship & benefits of diversification.
- Islamic investors no longer need to compromise religious beliefs in order to participate in equity markets.
- Investments in equities are acceptable investments for Islamic investors provided that they meet Sharia guidelines.
- Evolution of equity screening process.
- Ease of exit strategies and ease of funds availability.
- Higher return on stocks with private placement and middle market companies.

3.4 Bahrain Islamic Finance Industry.

The emergence of Bahrain as the Islamic banking and finance hub in the region and the establishment of the BFH, Bahrain Financial Harbour have added another dimension to the diversity of the financial activities and services available in the Gulf region. Islamic banking in Bahrain began in 1979 with the establishment of the Bahrain Islamic bank. As Bahrain developed as a major financial center in the region, many other Islamic banks and institutions were established in the country[32].

The activities of the Bahrain banks are diversified, serving the GCC, the USA and Europe.

The last statistics sourced from the Islamic financial directory show that the total assets of the Bahrain banks have increased from 2000 to 2002 in almost 12% and the net profit has soared by a 50% increase. The main financial highlights of the Islamic banking industry in Bahrain are shown in the following Table 3-8:

Financial Highlights (for the years 2000-2002 (US$ Million)-BAHRAIN				
	2000	**2001**	**2002**	**% (00-02)**
Paid-up Capital	818	758	717	***-12%***
Total Assets	2,835	2,949	3,050	***8%***
Cash & Cash Equivalents	396	385	438	***11%***
Contra Accounts	537	571	407	***-24%***
Total Investments and Financings	2,291	2,443	2,499	***9%***
Total Deposits	1,975	2,089	2,205	***12%***
Current Account and Savings	208	199	196	***-6%***
Restricted Investment Accounts	484	347	388	***-20%***
Unrestricted Investment Accounts	1,358	1,422	1,444	***6%***
Reserves	101	145	173	***72%***
Net Profit	55	76	83	***50%***

Table 3-8 Bahrain Islamic banking Financial highlights. Source: Islamic Financial directory, 2004.

[32] Dr Hussein, A.Khaled (2004), “Banking efficiency in Bahrain”, *IDB publications*, paper no.68, p16.

The total paid-up capital US$0.8Bn is relatively low compared to the number of Islamic institutions operating in Bahrain. This is to be compared with the Lebanese regulatory paid-up capital fixed at US$100m per bank, as per the law 575.

The total reserves in 2002 are of US$174m compared to total deposits (excluding the restricted Investment accounts) of US$3.85Bn. A reserve ratio of 4.5% is observed compared to 15% in Lebanon, providing a higher liquidity rate and less burden on the PLS distribution at the end of a period.

The total investment portfolio of Islamic banks in Bahrain is at US$2.5Bn in 2002 with a 9% growth over 2001.

The Bahrain Islamic Financial industry uses all modes of finance available in the market, including Sukuk. A sovereign Sukuk issue has been very successful as well. Bahrain is also planning a TADAWUL Sukuk exchange company, as stated in this article on Bahrain in the Oxford Business group, Emerging Bahrain 2006:

"The BMA (Bahrain Monetary Agency) has also been recently involved in preparations for the forthcoming Sukuk Exchange Centre Company, also known as Tadawul, with local media announcing early May that this outfit was likely to be granted an investment banking license from the authority by the end of this month and would be up and running by summer[33]."

Murabaha remains the major instrument of financing with 46% of the total, for its ease of operation and its relatively less complicated contractual and legal framework. Real estate comes in the second place with 28% of the total volume of operations followed by Mudaraba at 15% of the total volume of operations in 2002, as shown in Table 3-9 below.

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[33] Oxford Business group publication (2006), *Emerging Bahrain.*

Modes of Islamic finance-BAHRAIN (US$ Million)			
Mode Of Finance	**2001**	**2002**	**% of Tot.2002**
Murabaha	1,230	1,147	***46%***
Musharaka	56	85	***3%***
Mudaraba	323	370	***15%***
Leasing	164	140	***6%***
Istisna	30	53	***2%***
Salam	65	7	***0.3%***
Others: Real Estate	575	697	***28%***
Total	2,443	2,499	***100%***

Table 3-9 Modes of Finance-Bahrain. Source: Islamic Financial Directory, 2004
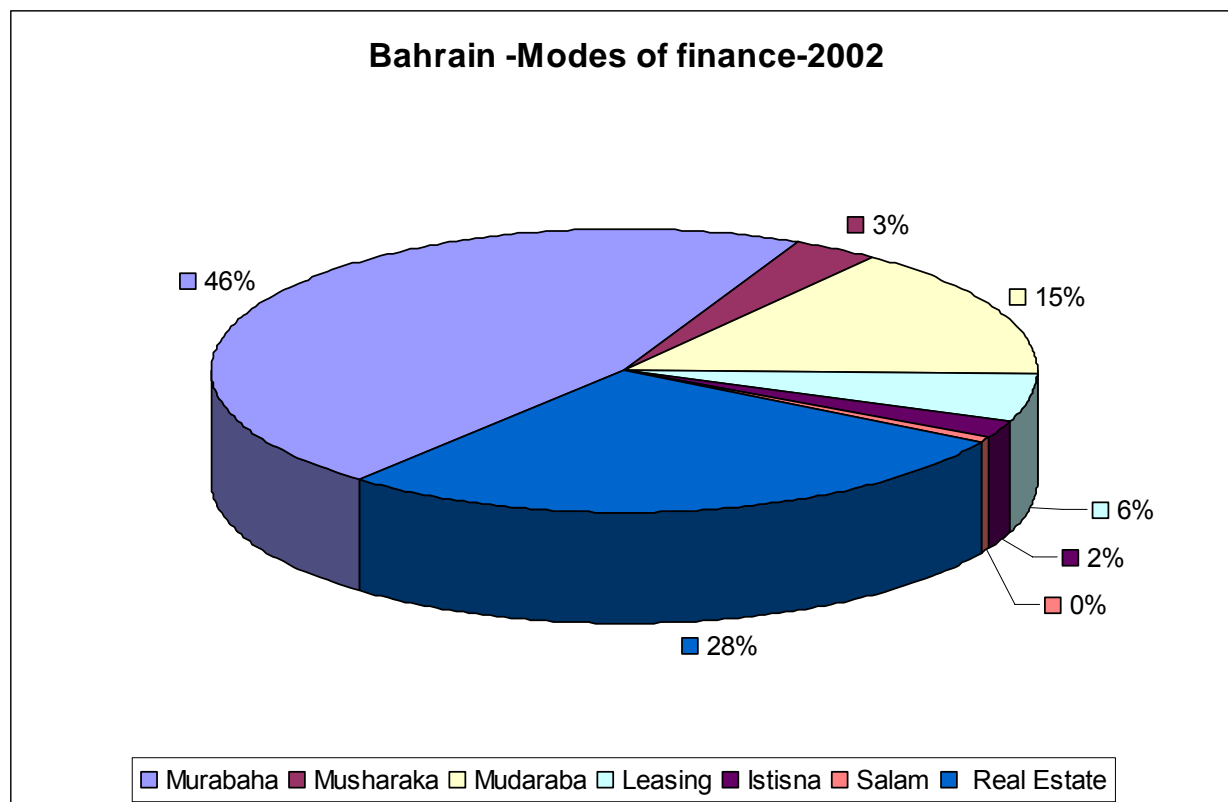
Figure 3-3 Bahrain modes of finance-2002

A medium and long term Ijara Sukuk program is set and running. Table 3-10 below summarizes the issuances in Bahrain, under the regulation and control of BMA[34]. Please note that the issuances are both in local BD or in US$ currency.

In addition to BMA's Ijara medium and long-term Sukuk issuance, a rolling program of monthly issuance of short term Islamic Sukuk Al-Salam, has been in place since June 2001. By April 2006, BMA had offered 59 issues of Sukuk Al-Salam. The value of each issue was raised to US$40 million from June 2005, from US$25 million previously.

In August 2005, the BMA introduced a separate rolling program of monthly issuance of short term Sukuk Al-Ijara. By April 2006, BMA had offered eight issues of Sukuk Al-Ijara. The value of each issue is BD10 million (US$27 million)[35].

BMA'S IJARA SUKUK PROGRAM						
Issue no.	**Issue Date**	**Issue Size**	**Maturity Date**	**Rating**	**Issue Price**	**Listing**
1	4/9/2001	US$100m	4/9/2006	-	5.25%	Bahrain Stock Exchange (BSE)
2	27-2-2002	US$70m	27-2-2005	-	4.25%	BSE
3	29-8-2002	US$80m	29-8-2007	-	4%	BSE
4	19-11-2002	US$50m	19-11-2005	**A-**	3%	BSE
5	27-2-2003	US$80m	27-2-2007	**A-**	3%	BSE
6	2/4/2003	US$100m	2/4/2008	**A-**	3.75%	BSE
7	27-5-2003	US$250m	27-5-2008	**A-**	60 basis points over six-month Libor	BSE
8	15-12-2003	US$50m	15-12-2006	**A-**	30 basis points over six-month Libor	BSE
9	30-6-2004	US$250m	30-6-2009	**A-**	45 basis points over six-month Libor	BSE, Luxembourg, Labuan
10	20-7-2004	BD40m	20-7-2014	**A**	5.13%	BSE
11	28-2-2005	BD30m	28-2-2010	**A**	4.50%	BSE
12	21-11-2005	US$230m	21-11-2011	**A-**	5.60%	BSE

Source: Islamic Finance review, Bahrain. Issue 13, Apr.2006- Pub: BMA

Table 3-10 Medium and Long term IJARA Sukuk, Bahrain.

[34] BMA is the Bahrain Monetary Agency, the financial and monetary regulatory body.

Bahrain OBU (Offshore Banking Unit), created in late 1970's, encourages the creation of Islamic Financial institutions with a special status for management and taxation. We consider this feature as a strategic differentiating property of the Bahrain Islamic Financial industry.

Summary of the main characteristics of the Bahrain legal and control system of Islamic banks:

- Body of control and legislation: BMA (Bahrain Monetary Agency)
- Double banking system: Islamic and conventional
- Sharia board for each bank.
- Obligatory management of liquidity gaps and maturity mismatch
- 4 types of Islamic banking:
    - Islamic commercial banks
    - Islamic investment banks
    - Offshore Islamic banks
    - Islamic windows in conventional banks

[35] BMA's Islamic Finance review, issue 13 April 2006.

3.5 Qatar Islamic Finance Industry.

"We take pride in introducing the first corporate Sukuk in Qatar. This is clearly a testimony of the market's readiness for more sophisticated products that address the evolving financing needs of companies in Qatar", says Mr. Ali Shareef Al Emadi, the acting Chief Executive of QNB (Qatar National bank), commenting on a US$375m Sukuk issuance for QREIC on the 13th of February 2006.

"HSBC wins the award ... for its US$700 million seven-year Islamic bond issue for the State of Qatar. The deal is the largest Islamic structured financing and longest-maturity bond issue to date and only the second sovereign deal of its kind. There was US$1.2 billion of demand, good geographical diversification and a 50/50 split between Sharia compliant and conventional investors."[36]

Qatar is considered the most booming and growing country of the GCC nowadays. The Qatari state is profiling itself to become the world's capital of energy with its gas and oil installation infrastructure projects hitting a historical high of US$25Bn. The growth has projected itself on the banking industry at large, a portion of which is reflected on the Islamic banking industry, as shown in Table 3-11 below.

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[36] Source: Euromoney 2004.

Financial Highlights (for the years 2000-2002 (US$ Million)- Qatar				
	2000	**2001**	**2002**	**% (00-02)**
Paid-up Capital	107	123	123	***15%***
Total Assets	1,706	2,015	2,410	***41%***
Cash & Cash Equivalents	71	81	933	***1212%***
Contra Accounts	98	109	264	***168%***
Total Investments and Financings	1,577	1,865	2,184	***38%***
Total Deposits	1,379	1,652	1,981	***44%***
Current Account and Savings	274	505	883	***222%***
Restricted Investment Accounts	0	24	9	
Unrestricted Investment Accounts	1,104	1,120	1,082	***-2%***
Reserves	35	44	69	***95%***
Net Profit	20	30	44	***120%***

Table 3-11 Qatar financial Highlights 2000-2002. Source: Islamic Finance directory, 2004

The big amount of liquidity and cash in 2002, almost at US$1Bn has grown at a meteoric percentage of 1212% or 12 times compared to 2000. The current accounts and savings have tripled in the same period from US$275m to US$883m. Yet this increase of cash liquidity is not reflected upon the investments that grew in a comparatively modest percentage of 38% over the period in study. Qatar's economy is booming and is witnessing a change in the economic and financial *modus operandi*: from a saving society to an investing one.

Still, Qatar Islamic banks are liquid, and the following Table 3-12 shows the various modes of financing in Qatar. The source is the Islamic finance director 2004.

Modes of Islamic finance- Qatar (US$ Million)			
Mode Of Finance	**2001**	**2002**	**% of Tot.2002**
Murabaha	1,426	1,716	***79%***
Musharaka	0	0	***0%***
Mudaraba	20	25	***1%***
Leasing	16	23	***1%***
Istisna	125	135	***6%***
Salam	0	0	***0%***
Others (specify) Real Estate	221	285	***13%***
Total	1,808	2,184	***100%***

Table 3-12 Modes of Islamic financing in Qatar. Source: Islamic finance directory, 2004.
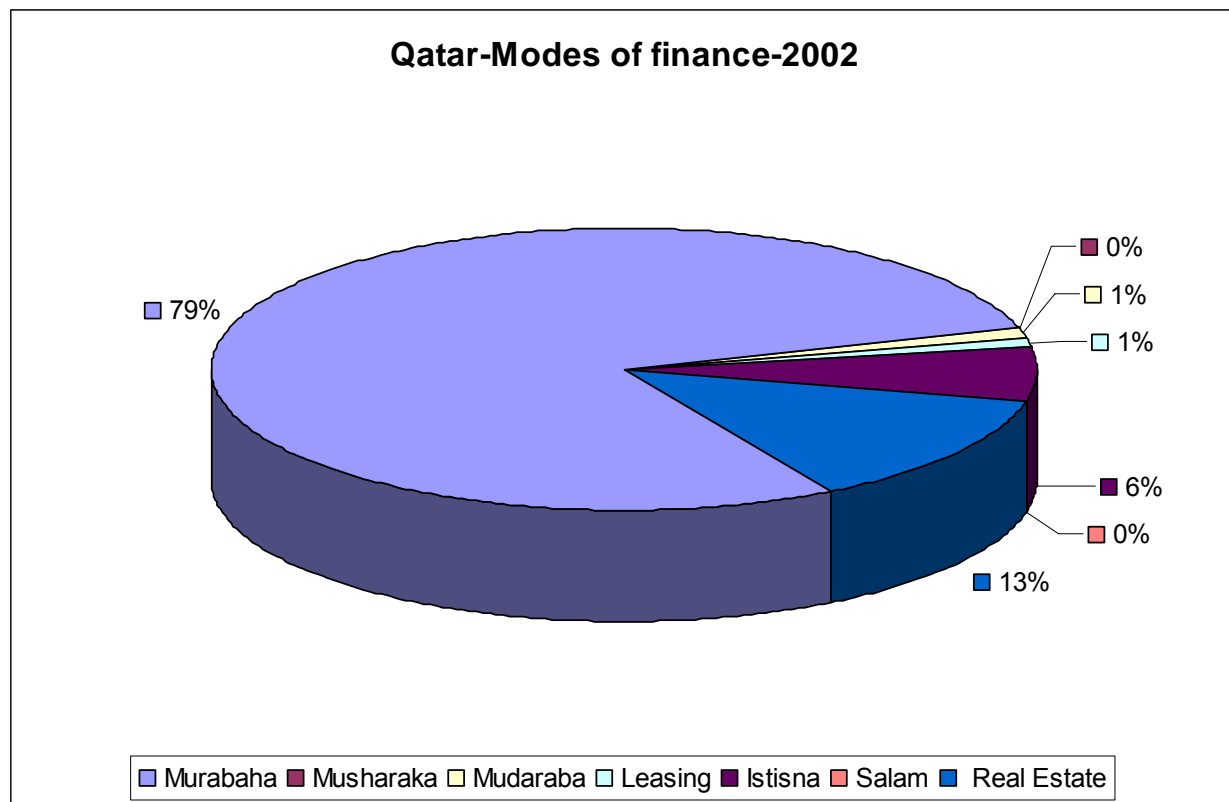
Figure 3-4 Qatar Modes of finance-2002

Clearly, Murabaha is the dominating mode of finance in Qatar. We would confidently affirm that the Istisna mode of finance is increasingly being used in the past 3 years, witnessing the growth of Qatari infrastructure projects in its oil and gas sector.

Qatar issued a sovereign Sukuk in 2004 for the total amount of US$700m. These Sukuk were dealt in Lubuan LFX bourse and its rating is A+ in the S&P rating standards.

Summary of the main characteristics of the Qatar legal and control system of Islamic banks:

- Legal body of regulation and control : QCB (Qatar central bank)
- Double banking system : Conventional and Islamic
- Double regulatory bodies
- No specific Islamic banking laws.
- Separate Sharia boards for each Islamic Institution
- Standard transparency enforcement for Islamic banks.

3.6 United Arab Emirates (UAE) Islamic Finance Industry.

Traditionally a trading entrepot, UAE financial services, both conventional and Islamic are becoming a major constituent of its GDP. In fact, UAE GDP, estimated at US$91Bn for 2005, is growing at a pace of 6.7%. Financial services constitute 9% of UAE GDP[37].

Islamic banking is nothing exotic in the UAE. In fact two Islamic institutions have been operating in the country for decades. The signs of growth in the Islamic industry stand out: Local banks are moving to become fully Islamic. Two examples to mention: NBS, National Bank of Sharjah became Sharjah Islamic bank in 2005, and Emirates Bank restructured MEB, Middle East bank into EIB, Emirates Islamic bank in 2004. The estimates are that Islamic banking in the UAE account for 20% of the overall local banking market.

It is very notable to learn that with just four Islamic banks in the UAE, the market volume of the UAE in investments and in deposit is 3.5 times the nearest competitor, Bahrain. This stronghold of low operational expenses (4 Islamic banks in UAE versus 26 Islamic banks in Bahrain for

[37] Refer to Appendix E for a summary of MENA region main economic indicators.

triple the investment volume) with high profit and high deposit level should be mirrored in Lebanon. This is an example of efficiency and resources allocation very dear to the Lebanese industry survival and growth.

Other key signs of rise in the Islamic banking industry in the UAE are the frequent use of Islamic structures in project finance and debt capital market transactions[38].

The UAE Islamic banks financial highlights for 2000-2002 are depicted in **Table 3-13** below.

UAE- Financial Highlights (for the years 2000-2002 (US$ Million)				
	2000	**2001**	**2002**	**% (00-02)**
Paid-up Capital	544	639	644	***18%***
Total Assets	4,392	6,394	8,149	***86%***
Cash & Cash Equivalents	309	626	499	***61%***
Contra Accounts	690	608	656	***-5%***
Total Investments and Financings	3,999	5,679	7,502	***88%***
Total Deposits	3,486	5,479	7,114	***104%***
Current Account and Savings	623	13,749	1,744	***180%***
Restricted Investment Accounts	0	0	0	
Unrestricted Investment Accounts	2,863	4,104	5,369	***88%***
Reserves	32	192	202	***515%***
Net Profit	48	84	79	***63%***

Table 3-13 UAE financial highlights. Source: Islamic finance directory 2004.

The Islamic financial industry in UAE is growing at a slower pace then Qatar and Bahrain. Yet, it boasts a prominent investment volume of US$7.5Bn three times more then its nearer competitor Bahrain. The investment growth is substantial at 88% over the period 2000-2002.

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[38] MEED Middle East Economic Digest 49 (2005), No 0047-7230, “Principle grows profit”, p.2.

The modes of finance in the UAE reflect as well this feature of high investment level, with a prominent leasing volume growing to half a billion US$ in 2002, as shown in the Table 3-14 below.

Modes of Islamic finance- UAE. (US$ Million)			
Mode Of Finance	**2001**	**2002**	**% of Tot.2002**
Murabaha	2,483	3,530	***47%***
Musharaka	0	0	***0%***
Mudaraba	0	0	***0%***
Leasing	134	535	***7%***
Istisna	0	0	***0%***
Salam	0	0	***0%***
Real Estate	3,062	3,437	***46%***
Total	5,679	7,502	***100%***

Table 3-14 UAE Modes of finance. Source : Islamic Finance Directory 2004.
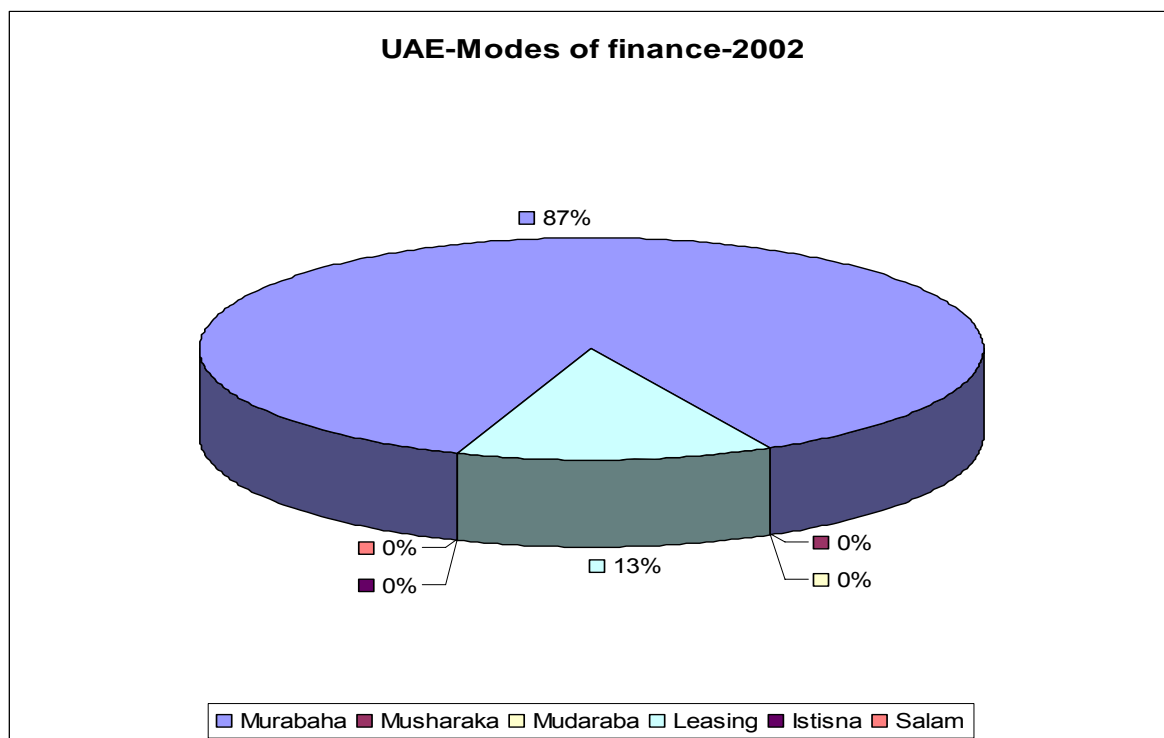
Figure 3-5 UAE modes of finance - 2002

A 50-50 split between Murabaha and real estate financing, with leasing mode being the most rapidly growing sector with almost 300% increase between 2001 and 2002.

It is worth noting the US$1Bn Sukuk issue by Dubai's department of Civil Aviation (DCA). The deal was upsized due to the excess subscription of US$1.2Bn.

Summary of the main characteristics of the UAE legal and control system of Islamic banks:

- Legal body of regulation and control : United Arab Emirates central bank
- Islamic banking law exists.
- Dual banking system: conventional and Islamic.
- Islamic windows authorized
- Separate Sharia board for each institution.
- Basel I and II capital adequacy regulations enforced.
- International accounting norms enforced.

3.7 A Comparative study of Islamic Finance Industry: Lebanon, Bahrain, UAE and Qatar.

3.7.1 Scope and limitation of the study

The scope of this comparative study is to assess the relative importance and effect of the Islamic financial sector of each of the countries. It is by no means a systematic qualitative evaluation of the depth of the industry in each market. Used mainly to compare cross-country variables rather than absolute indices of performance, the main purpose of this section is to draw basic indicators of relative performance to suggest development directions and growth strategies for Lebanon.

We rely primarily on the Islamic finance directory 2004, published by the GCIBFI, the General council of Islamic Banks and Financial Institutions, Bahrain, and their website www.islamicFi.com. We could not find a cross reference of the data pool used in this work, and we are cautious about it.

Lebanon is not an oil producing company, and its GDP constituents are different from its other peers. The scale and volume of operations could not be compared. It is however possible to draw

a parallel between Lebanon from one side and the other countries. In short, we will not be comparing sizes of markets and drawing conclusions but rather we will be comparing services, legal framework and potential areas of growth in Lebanon.

3.7.2 Lebanon-GCC comparative tables

Basic Ratios	Bahrain	Qatar	UAE	Lebanon
ROA	2.7%	1.8%	1.0%	0.7%
ROE	11.6%	36.0%	12.3%	2.8%
Investment/Deposit	113%	110%	105%	87%
Total Assets/Equity	4:1	20:1	13:1	4:1
Investment/Total Assets	82%	91%	92%	46%
Current Accounts/Total Deposits	8.9%	44.6%	24.5%	16.1%
Restricted Accounts/Total Deposits	17.6%	0.5%	0.0%	7.0%
Unrestricted Accounts/ Total Deposit	65.5%	54.6%	75.5%	76.8%
Profit/ Investments	3.3%	2.0%	1.1%	1.4%
Profit/Deposits	3.8%	2.2%	1.1%	1.3%
Reserve Ratio	8%	3%	3%	15%

Table 3-15 Comparative table of basic ratios for Islamic banks.

Notorious figures:

- Bahrain has the highest ROA ratio of 2.7%. Lebanon's ROA is at 0.7% due to the fact that the Islamic Financial institutions are still at an early stage of inception and operation. Bahrain ROA reflects primarily a managerial efficiency. Bahraini IFI's have become very efficient in converting the institutions' assets into earning at a faster pace then the other countries.
- Qatar ROE is the highest among the countries in comparison at 36%, tripling its nearer competitor UAE at an ROE of 12.6%. Qatar's IFIs shareholders are the best served in the area. Their investment in Islamic banking is giving very high return. The boom of project finance in Qatar is primarily the cause for such a high ROE ratio. We cannot assess at this stage of its lifecycle, the ROE of the Lebanese Islamic banking sector. Time is needed to reach the quiescent point of equilibrium to be able to judge.
- The burden of the 15% reserve ratio in Lebanon is reflected on the low investment/deposit ratio of 87% compared to 113% in Bahrain. The reserve ratio tolls

heavily on the shoulders of the management of IFIs in Lebanon and would eventually produce a lower net profit margin to the depositors. The IFIs in Lebanon cannot benefit from the interest paid on the reserves by the central bank, and hence 15% of the capital of depositors is not producing any revenues.

- The leverage effect of the ratio Assets/Equity reflects the risk level of the institution. It is clear that Qatar has the highest leverage effect of 20:1, i.e for every $1 of equity the Qatari IFIs have $20 in debt to produce the same ROE. To note that this general formula holds:

$$ROE = ROA \times \frac{\text{Total assets}}{\text{Equity}}$$

Clearly, as earnings efficiency represented by ROA declines, the firm must take on more risk in the form of higher leverage ratio to be able to achieve its desired rate of return to shareholders, ROE. Lebanon, with a safer leverage of 4:1 reflects the stringent and safe control exerted by the central bank to safeguard the interests of the depositors. It is safer for investors to establish or invest in equities of IFIs in Lebanon ten in Qatar.

- Lebanon's Investment/ Assets ratio, below 50% for the time being reflects the phase of establishment and introduction in the life cycle cure of the industry. Heavy investment in marketing and public relations as well as in locative assets would lower this ratio during this early period. We shall see an improvement of this ratio in the coming years, and the growth in the Lebanese IFIs should be more pronounced then the growth in the other countries. It is a new market, a new investment approach and a new venture all together.

The modes of finance in Bahrain, Qatar, UAE and Lebanon are depicted in the following Chart-Table 3-16.

	Bahrain	Qatar	UAE	Lebanon
Murabaha	46%	79%	47%	73%
Musharaka	3%	0%	0%	19%
Mudaraba	15%	1%	0%	1%
Leasing	6%	1%	7%	1%
Istisna	2%	6%	0%	6%
Salam	0%	0%	0%	0%
Real Estate	28%	13%	46%	0%
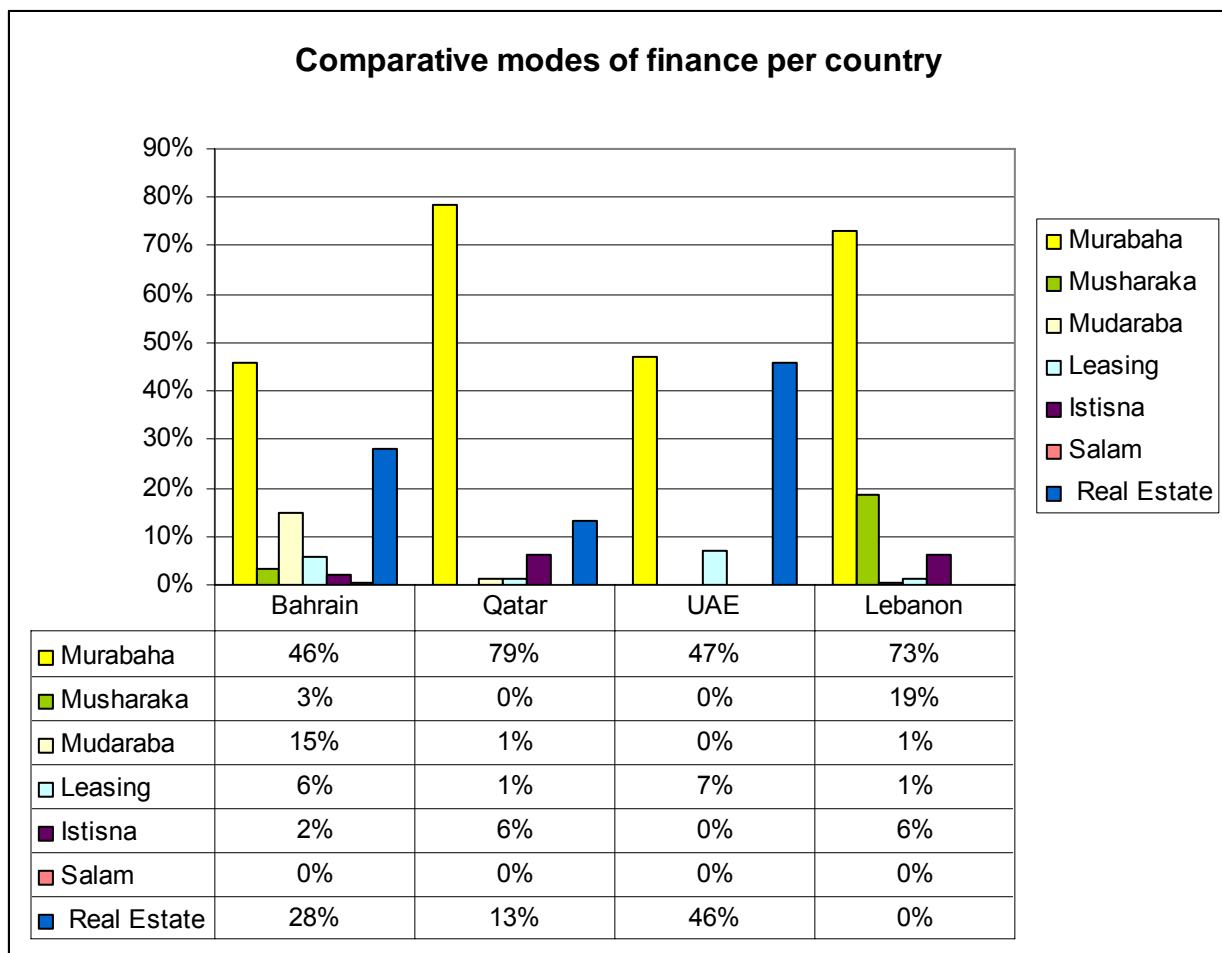
Table 3-16 Comparative modes of finance per country as a percentage of total per country.

We did not include in this table the values of each mode of finance lest the comparison will be disproportionate. The total value financed in Lebanon amounts to US$79m compared to its nearer competitor Qatar with US$2,184m. As we mentioned earlier in this paper the finality for this study is to extract tendencies and recommendations to be applied to the Lebanese Islamic Financial industry. The particularity of Lebanon's industry is apparent with an important percentage of Musharaka (19%), unique in the region, with Bahrain Musharaka at 3% as its nearest peer.

We also note with relevance the existence of a comparatively prominent Istisna activity at 6% similar to Qatar. Indeed, Lebanon financial needs in building premises and infrastructure reflects on the facility of Istisna being more project friendly and risk sharing, as compared to a conventional debt. This particularity of the Lebanese market will be discussed in the next chapter, shedding a light on the "crowding out" effect of the capitals to the private sector due to the substantial vacuum in cash that the public expenditure and indebtedness is creating in the Lebanese market.

The essence of the Islamic Financial precept in profit and loss sharing is reflected in Musharaka and Istisna in Lebanon. The social and collaborative dimension of the Islamic Sharia way of doing business emerges. Islamic finance is not about charity ONLY; it is about making profit while enhancing the quality of life through social endeavors.

We conclude this section of our paper by compiling a cross sectional comparative table between the countries under study and the Lebanon. Table 3-17 below summarizes some of the prominent data on :

- Economic highlights
- Islamic financial industry highlights
- Strategic positioning highlights.

This table sheds a light on the major characteristics of each market-country. Some of the Lebanese highlights are marked in red to show areas where improvements are possible. Our aim in the coming section is to address the question of positioning Lebanon as a hub of Islamic finance in the area.

		Bahrain	Qatar	UAE	Lebanon
	GCC-Lebanon Islamic Finance Industry comparative table				
ECONOMIC HIGHLIGHTS	Population in mn	0.74	0.8	4.6	3.8
	GDP, US$Bn	12.83	35.44	117.06	20.88
	GDP growth %	5.9	6.7	6.7	0.1
	Per capita income US$m	17	44	25	3
	Moody's rating	Baa1	A1	A1	B3
ISLAMIC BANKING SECTOR HIGHLIGHTS	No. of Islamic banks	26	4	5	2
	Capital paid-up US$m	717,702	123,508	644,484	47,000
	Total deposits US$m	2,205	1,981	7,114	102
	Total investments US$m	2,499	2,184	7,502	89
	Min. capital US$m	5	10	5	100/20
	Reserve %	5	4	5-8	15
	Murabaha	Y	Y	Y	Y
	Musharaka	Y	Y	Y	Y
	Mudaraba	Y	Y	Y	Y
	Istisna	Y	Y	Y	Y
	Sukuk	Y	Y	Y	N
	Salam	Y	Y	Y	Y
	Ijara	Y	Y	Y	Y
	Securitization law	N	N	N	Y
	Fiduciary Law	N	N	N	Y
	Funds law	N	N	N	Y
	Capital market	Y	N	Y	N
	Secondary market	Y	N	N	N
	Years of operation(2006)	26	36	4	2
	Sharia board	Independent	Independent	Independent	Independent
	Dual system banking	Y	Y	Y	Y
	Dual currency	Y	Y	N	Y
	Double stamp tax	N	N	N	Y
STRATEGIC HIGHLIGHTS	Red tape	low	low	medium	severe
	Strategic positioning	Offshore banking units	Biggest infrastructure projects	Highest level of deposits/Center of trade/foreign companies' HQ	Secrecy/fiduciary law/ Highly regulated banking sector

Table 3-17 GCC-Lebanon Comparative table of major indicators. Compiled from various sources.

Chapter 4
Lebanon, a potential hub for Islamic Financial industry in the MENA region- A systematic approach.

4.1 Introduction: Lebanon and the macro-economic environment of the MENA region.

The clock strikes twelve noon and one can hear the chimes of the church bells announcing midday in the busy streets of Beirut. Only few minutes later, the muezzins in their thin needle shaped minarets announce the prayers of midday. You are in Beirut, a mixture of avant-garde architecture, hectic organized chaos and Multilanguage local dialect. The cosmopolitan threading of the dwellers of Beirut city announces a polychromatic texture of cultural, commercial and religious landmarks. Beirut is still alive.

Years of absurd destruction and civil war could not sway the polarizing character of Beirut from staying alive. The reconstruction period started after the Taif Agreement in 1990, officially ending the civil war, involving more then 5 billion dollars in direct investments, rehabilitating the destroyed and now archaic infrastructure of the country and reconstructing the downtown center of Beirut, alas center of street-to-street fighting during the civil war.

The Lebanese economy suffered a jolt during 2005 after the assassination of former prime minister Rafic Hariri. GDP Growth dropped sharply from 4% to 0%[39], with a gross public debt reaching in November 2005 US$37.7bn, up 5.3% over the same period in 2004. While efforts intensified to raise funds to pay down this state debt both through the Beirut donor conference and by re-launching the dormant and politically sensitive privatization program[40], the absolute level of debt continued to increase during 2005 and through 2006.

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[39] See Appendix F for main economic indicators from 2001-2006

[40] Oxford business group (2006), *Emerging Lebanon*, P41.

The banking sector of Lebanon boasts a tradition of stability and expertise, enforced by a stringent and very well respected and admired banking secrecy law in the MENA region. In recent years, the region has witnessed a substantial increase in the oil barrel price, increasing the liquid reserves of the petroleum producing countries. The GCC investors, however, have shown a shift in their investment behavior after the 9-11 events: The quest for new areas and countries of investment and a marked tendency to invest in Sharia compliant products are observed[41].

The size of the market in the surrounding countries of Lebanon might shade at a first glance the hope of a fully developed Lebanese Islamic financial industry. Yet, relying on the experience of Malaysia and its progressive 5 years plan, and considering that the Islamic financial industry is still in the phase of development and introduction and not yet in its maturity life cycle, we can confidently affirm that the Lebanese Islamic Financial industry has a major and decisive role to play in the MENA region.

Currently, there are estimated to be over 265 Islamic Financial Institutions around the world[42], with a market capitalization in excess of US$13Bn. Total assets are estimated at US$262-300Bn with financial investments above US$400 Bn. Deposits in Islamic banks are estimated to be around US$202Bn worldwide and the average annual growth rate of the Islamic banking industry ranged at 15-20% over the past decade.

[41] Abdullah, Daud Vicary (2006), Managing Director, “Strengthening the role of Islamic Finance in Economic Development”, *3rd IFSB Summit in Beirut.*

[42] Please see Appendix D for a list of financial institutions.

Figure 4-1 below represents the assts allocation in Islamic banks, as of 01-2006.
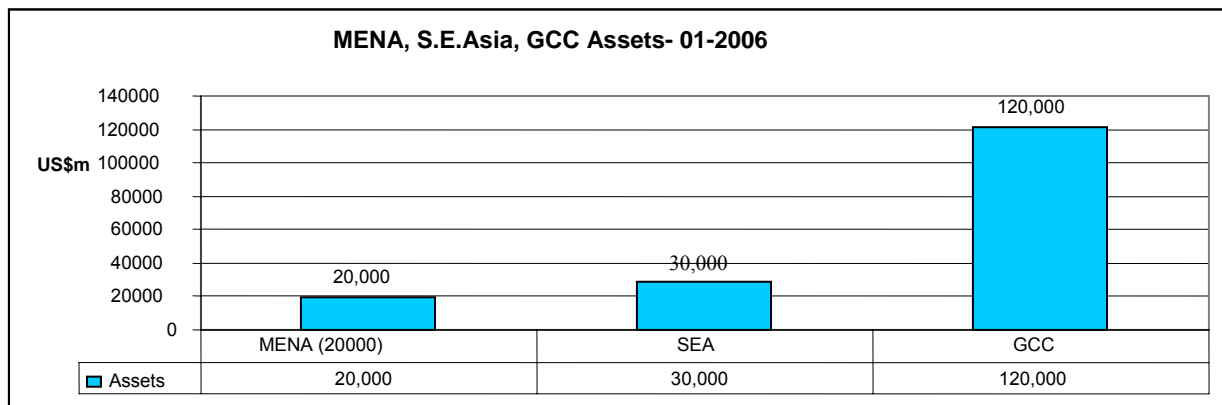
Figure 4-1 Asset allocation in Islamic banks, as of 01-2006. (Source: compiled by author)

Borrowing the brilliant affirmation made by Mr. Daud Vicary Abdallah, GM of HongLeong Islamic bank Malaysia, describing Malaysia as a regional Islamic financial hub :

"The most successful market is not necessarily the largest in size, but the most open and dynamic to change"[43].

What are then the factors favoring the Lebanese market place as a solid candidate for becoming a hub of the MENA Islamic finance Industry.

To answer this question, we propose to tackle the following issues:

- Factors influencing the Lebanese market.
- Internal Islamic finance industry in Lebanon: what should be done to increase the volume of domestic investments and placements?
- Cross border Islamic finance operations: what should be done to attract funds from outside investors? What are the possible feasible instruments or financial setups?

[43] Idem 41

4.2 Factors influencing the Lebanese market place.

An important report published by the United States department of commerce-2006, identifies clear investment and commercial opportunities with Lebanon[44]. The report cited the absence of controls on the movement of capital and foreign exchange, a highly educated labor force, a dollarized economy, limited restrictions on investors, and the quality of life as factors that have encouraged a number of foreign companies to set up offices in Lebanon in recent years. Also, there are no delays in remitting investment returns except for the normal time required by the banks to carry out transactions. On a separate note, we should mention however the existence of a complicated red tape procedures hindering the efficiency and competitiveness of Lebanon as a market place for investment.

Lebanon can play a major role in the Islamic financial industry in the region. *"Our sound banking system, our tradition and experience in international finance, our respected banking secrecy law and our highly trained and educated human resources confirm once more that Lebanon is set to play a leading role in the development of Islamic Financial industry at large"*, says Dr François Bassil[45], Chairman of Byblos Bank, Lebanon and chairman of the banking association of Lebanon.

Many factors, external and internal, influence the strategic positioning of Lebanon in this industry. In the coming sections we will explore some of the major external and internal factors that modulate the penetration and trenching of the Islamic financial industry in Lebanon.

4.2.1 External factors

1. The abundance of cash resources in the MENA region

   Analysts concur that the oil boom started in the mid 70's of the last century, and with some ups and down has continued to grow until the recent May 2006 high price of US$75 per barrel.

[44] Country Commercial Guide (2006), "US Department of Commerce publication", Lebanon.

[45] Interview by the author with Dr Francois Bassil on fifth of May 2006.

The economy of most MENA region countries is based on the petroleum industry. We are witnessing a shift in this trend towards including transit trade (Dubai) and financial services (Bahrain), still the contribution of the oil and gas sectors to the GDP of most of the MENA is around 20-25%. Oil and gas exports engross the treasury of the oil rich country creating a cash reserve surplus.

2. The shift in the political climate post 9-11 events and investors' funds migration.

   After the events of September 11, the hardening of attitudes both in the West and in some Islamic countries has precipitated the flow of funds from the West to the OPEC countries, with a large share being reinvested according to Sharia guidelines and principles[46]. The figures from the Bank of International Settlements show that the flow from Western banks by OAPEC (Organization of Arab Petroleum Exporting Countries) to the Middle East has been on the rise since the end of 2001.The rising trend continues and Sharia compliant investments have received a fair share of these funds.

3. The emergence of Islamic Financial hubs in the area.

   In fact, as seen and analyzed earlier in this paper (Ch.3), Bahrain with its OBU (Offshore banking Unit), Qatar with its mega infrastructure and energy projects and the UAE with its big volume of deposits and investment portfolio in Sharia complaint instruments are shading the opportunities for other plazas to emerge and grow to a comparative scale. This situation is a tacit barrier of entry to other possible players in the Islamic financial industry. It will limit the investment and placement opportunities of new markets to the local clients.

4.2.2 Internal factors

1. The banking secrecy in Lebanon.

[46] Hume, James (2004), "Islamic Finance: provenance and prospects", *international financial law review 23 no5 PP48-50.*

Promulgated in Article 2, law dated September 02 1956; the Banking secrecy law of Lebanon is a prominent factor of the development of the Lebanese banking sectors in recent years.

"The banking secrecy is absolute in favor of the clients of the… banks which cannot disclose to any private person or any administrative, military or judicial authority, the names of their clients, their assets and any fact brought to their knowledge relating to their clients' operations (opening of a current account, safe box, lease etc…).
This ban applies, not only to the banks' directors and employees, but also to any person who, by reason of its quality or function, has knowledge of the books, operations and banking correspondence such as Notaries Public, lawyers or auditors.
Accordingly, the banking secrecy can be opposed to the Lebanese tax authority and no distrait can be carried out on the assets deposited in the banking establishments without the written authorization of their owners[47]*." (Abi-Chahla, Nicole, et al. 2001)*
On the other hand, the enforcement of the banking secrecy provisions covers and includes the fiduciary contracts. Any institution duly authorized by the BDL (Lebanese Central Bank) can undertake fiduciary transactions in Lebanon.
Thus, these establishments being subject to the banking secrecy are compelled not to disclose the identity of the "constituent" and/or the "beneficiary" to any third party regarding the operations relating to the fiduciary patrimony even when a publication or a statement is required by the law.
In light of the above, the rigidity of the Lebanese banking secrecy and its implementation make the particularity and specificity of the Lebanese banking system in general most attractive to foreign and local investors.

2. The human resources of Lebanon.

[47] Abi Chahla, Nicole & Aziz, Anissa (2001), "Banking secrecy in Lebanon », *Etude Badri et Salim el Meouchi.*

The human resources and the Lebanese work environment are of highly trained and specialized labor. In fact Lebanon has the fundamental building blocks needed to become a regional center for technology including a highly educated and multilingual workforce, a strong private sector, world-class advertising firms, and multilingual media content providers and web portals, affirms the USA Department of Commerce 2006 Country Commercial Guide for Lebanon[48]. Further, Lebanon is an ideal location for establishing a regional office to cover the Levant region, including Iraq, it affirms. The Lebanese market has been used as a platform for testing U.S. technology prior to introducing it to the rest of the Levant market, and opportunities exist to form partnerships with local IT companies, especially in areas such as software and telecom solutions for small and medium-sized Lebanese companies, and medical and healthcare sectors.

Skilled labor is Lebanon's main asset. The diversity of the specializations in Lebanon allows all productive sectors to rely upon a ready-to-operate human resources potential. The Islamic banking services and industry, by its nature being highly specialized and intricate, encounters no hurdles in recruiting high and medium ranked officers amongst the best qualified Lebanese professionals, says Dr Jamil Jaroudi, DGM of Arab Finance House –Lebanon and one the leading pioneers of Islamic financial industry in Lebanon[49].

3. The academic and educational industry of Lebanon.

Prime Minister Fuad Sanioura, in his speech in the opening ceremony of the " Business Opportunities in Lebanon[50]", described eloquently this property of the Lebanese society by "**The Economy of Knowledge**".

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[48] Country Commercial Guide (2006), "US Department of Commerce publication", Lebanon.

[49] Please see Appendix C for more details on the interview with Dr Jaroudi.

[50] "Business Opportunities in Lebanon", 21-22 June 2006. Dbayeh Convention center, Organized by InfoPro and Lebanon Opportunities magazine.

Total national spending on education is high (9% of GDP), with 60% of this from private sources. Adult literacy reached 85% in 1997 (65% in 1972), primary schooling is almost universal, and net enrolments in secondary education are around 50%. Post-secondary enrolments are around 25%. Gender differences are not particularly significant[51]. Many specialized financial, accounting and managerial higher educations programs are available in the country from renown international universities. We mention the ESCP-EAP program and university in Beirut, ESA-Beirut (Ecole Supérieure des Affaires) offering several field related international masters degree. Lately, The ESA established the IFQ (Islamic Finance Qualification), a qualification program in conjunction with Securities and Investment Institute- London and the BDL.

4. The Lebanese fiduciary law.

"The law of fiduciary credits allowed specifically the banks operating in Lebanon to conduct all banking and financial businesses, use Islamic bank instruments and establish investment funds, provided that banks assure administrative staff related to these operations." Says H.E. Mr Riad Salemeh, Governor of BDL, in his speech "The Lebanese Emigrants Facing the Challenges of Globalization and Bank Legislations" February 28th, 2002 - Le Bristol Hotel Beirut.

In fact, the Lebanese fiduciary law opened up the possibilities of investments and financial engineering to a myriad of instruments never before explored in the Lebanese market. Securitization set ups were engineered under this law long before the securitization law was promulgated. Many an Islamic Financial instrument could be engineered to comply with Sharia precepts without the recourse of a proper instrument's law, as is the case today.

5. The Lebanese securitization law.

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[51]Country strategy paper (2006), Medium term challenges Euro-Med partnership, Lebanon, P10.

6. The Lebanese funds law.
7. The dual currency system and the Lebanese Pound stable exchange rate to the dollar.

   In the absence of Islamic currency swaps, receivables in the GCC countries are local-currency denominated. Hence, the assets' currency commands all issued notes (Boustany et al.) for a securitization process, to avoid mismatching. This dilemma is overcome in Lebanon, due to the natural pegging of the Lebanese lira to the dollar on a stable basis for the past 9 years now.

   The (BDL), Banque du Liban, is maintaining a policy that enables the Lebanese banking sector to deal with the markets in the currency chosen by the latter, without endangering it or submitting it to unnecessary risks[52].
8. Cultural permeability and the diversity of the Lebanese society.

   The Lebanese society is multicultural and multi confessional. The people of Lebanon, the system and the openness of its dynamic people bestow on the Lebanese society an acceptance and an admiration across the region. It is true, the Lebanese society is facing many challenges as to the long term stability and coexistence of all its contradictory, yet enriching, facets. Still, the truth is that Lebanon remains the pole of attraction of tourism from all over the globe, and estimates for summer 2006 predict a high affluence of MENA tourists in the 1,5million[53].
9. Untapped productive and agricultural sectors.

   The crowding out effect creates a vacuum of financing resources to SME (Small and Medium Enterprises) due to the big need of the government for liquidity through heavy borrowing from the local banks. These sectors are in need of urgent and long-term credit facilities to cover their need of working capital, capital expenses and

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[52] H.E. Mr Salemeh, Riad (2002), Governor of BDL, "The Lebanese Emigrants Facing the Challenges of Globalization and Bank Legislations", *Le Bristol Hotel Beirut*.

[53] Al Nahar newspaper, 12-06-2006. Economic section.

infrastructure development. This indeed is exerting a big pressure on the productive and agricultural sector in Lebanon[54]. Add to this the difficult and tedious task, and sometimes preemptive condition, of guarantying the SME credits with a real asset collateral of up to 200% of the value of the principal. Those SMEs and agricultural projects, not able to advance such high a threshold of collaterals, are doomed not to access a banking loan at all.

10. Lebanon Sovereign rating
11. Lebanese Tax laws and red tape.
12. The Lebanese Diaspora

    Estimates of the Lebanese Ministry of Foreign affairs report that some 6 million Lebanese and Lebanese descendants live outside of Lebanon in a permanent or transient basis. In a report written in 2003 by Mr. Nassib Ghobril[55], then deputy manager of Audi Bank research department, the amount of money transferred to Lebanon from its Diaspora were evaluated at US$2.5Bn in 2003. These funds are hand carried or bank transferred to families in Lebanon, and some 55% are deposited in commercial banks. A substantial percentage of these depositors, that we estimate around 25% of the funds deposited, would be interested in depositing their savings and funds in Sharia compliant institutions. Our estimate would evaluate the Sharia seeking funds that are currently deposited in commercial banks in Lebanon to be around US$350Mn.

13. The governmental economic reform plan.

    The government of H.E. Prime Minister Fuad Sanoiura, has presented in the second quarter of 2006 a reform plan on economic, monetary, social and administrative issues.

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[54] Interview with Dr Fadi Gemayel. Please see section 2.3 of this paper, and Appendix C

[55] Please see Appendix C for more details on the interview with Mr. Nassib Ghobril, Head of Byblos Bank research department.

This plan was exposed to the public in details by HE Prime Minister Sanioura and their Excellencies Minister Jihad Azour, minister of finance, Minister Sami Haddad, minister of economy, in "Business Opportunities in Lebanon-2006[56]". During the round table organized, the plan clearly exposed the need to increase the government revenues and reduce the government spending to be able to meet a growth rate of 5% in 5 years and 8-9% in 10 years. The plan also considers reducing the budget deficit by 2010. Part of the plan to achieve this goal is to privatize some of the public companies. EDL (Electricité du Liban), land telephony, cellular telephony, MEA (Middle East Airline company and the port of Beirut are included in the privatization bracket. The target date to achieve the privatization plan was set to 2008 as a maximum.

4.2.3 S.W.O.T.[57] analysis: the Lebanese Islamic Finance Industry

4.2.3.1 Methodology and boundary conditions of the matrix

The Strengths, Weaknesses, Opportunities and Threats detected and exposed in this matrix analysis were drawn directly from the qualitative fact finding study conducted through the one-to-one interviews by the author with the personalities and professionals listed in Appendix C. We strived to classify the grade of importance or intensity of each feature, property or modulator of the Islamic financial industry in Lebanon analyzed, in a Licker-scale like matrix. The classification results are reflected in the order of appearance of each property in its relative quadrant, the first being the most important or of the most intensity. However, the sample size of forty two (42) interviewees does not statistically represent, to a satisfactory level of confidence, the compound stratified sections of the Lebanese economic and financial society. This study remains qualitative in its nature and the inferences and conclusions we draw from the

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[56] "Business Opportunities in Lebanon", 21-22 June 2006. Dbayeh Convention center, Organized by InfoPro and Lebanon Opportunities magazine.

[57] Strengths, Weaknesses, Opportunities and Threats matrix analysis.

compilation of our results in this SWOT analyses might be inconclusive, necessary but not sufficient.

Table 4-1 depicts the SWOT analysis matrix for the Lebanese Islamic Finance Industry.

SWOT Analysis

EXTERNAL	**Strengths** S1. Banking secrecy in Lebanon. S2. Prospect of a radical economic and monetary reform. S3. Economy of knowledge. S4. Lebanese regulations. S5. Absence of cultural shock. S6. Specialized human resources.	**Weaknesses** W1. Lebanese tax laws and red tape. W2. Lebanese sovereign rating. W3. Untapped productive and agricultural sector. W4. Lack of modern infrastructure.
INTERNAL	**Opportunities** O1. Abundance of cash resources in the Region. O2. Shift in the instruments trends post 9-11.	**Threats** T1. Emerging of Islamic Financial hubs in the area. T2. Bahrain offshore unit and financial harbour. T3. DIFC Dubai Islamic Finance Center. T4. Placement of petrodollars in Malaysian markets.

Table 4-1 Lebanese Islamic Finance Industry SWOT matrix

4.2.3.2 Action plan derived from the SWOT matrix analysis.

How do we attract funds from investors willing to place their liquid assets in Lebanon? Once placed, how are we to use them to produce value for Lebanon and for the investor? The idea seems very simple and straightforward, yet difficult to achieve. Lebanon Financial Industry

attracts funds by creating projects and designing investment schemes and opportunities that yield attractive revenues for the risk involved.

From the SWOT matrix above, and cross-breeding what Lebanon is (Strengths and Weaknesses) with what we Lebanon is facing (Opportunities and Threats), the following "fronts" of action are presented. The list below is not exhaustive, and we have chosen to stress on the following issues only. We perceive its implementation as the building block for establishing in Lebanon an Islamic Financial hub. Sections 4.3 till 4.8 include the development of each and every action point suggested, respectively:

1. In view of the cash excess pool, the first project eligible for a wide scope Islamic Financing would be Solidere. This issue is developed in section 4.3.
2. The government is undertaking a substantial and radical economic reform. The major ingredient of which is to reduce the deficit/GDP ratio. The government suggests a privatization plan of EDL, land and cellular telephony, MEA and the Beirut port to add to its revenues and hence lowering the debt level and the service of the debt. We suggest a scheme for this privatization plan in compliance with the Sharia principles. The Islamic privatization alternative is discussed in section 4.4.
3. Given O2 and W4, we will suggest a 5 years plan to launch an infrastructure program financed by Sharia compliant funds from the GCC region. Lebanon is in need to renew its utility, land transportation, public transportation and waste disposal infrastructure. We will suggest an Islamic Financial instrument and modes of finance to achieve these projects tapping the liquidity pool available in the GCC region. This issue is discussed in section 4.5.
4. The productive and agricultural SMEs are suffering from lack of finance due to the crowding out effect and the lack of collaterals discussed earlier. Provided those companies and individuals pass the Sharia screening criteria, the IFIs in Lebanon could consider a Mudaraba fund scheme to finance these activities with funds from the GCC area and from local investors. A discussion of a Salam and parallel Salam scheme will

also be considered for some major Lebanese agricultural products and by-products, namely: Olive oil, honey and citric. This issue is discussed in section 4.6.

5. Given the high unemployment rate and the proliferation of tax evasion by unorganized small micro-companies and home based small family businesses, the need of a nationwide micro finance scheme is urgently needed. We will suggest an Islamic microfinance nationwide project for micro companies and we will discuss its components and variables in section 4.7.
6. Our closing remarks will focus on the Islamic funds. Lebanon could become a launching pad for Islamic funds managed through a fiduciary contract. This strength of the Lebanese financial regulation opens a myriad of possibilities to Islamic banks willing to explore this untapped terrain of wealth management. Islamic funds are discussed in section 4.8 of this chapter.

4.3 Solidere, a pilot project for Islamic Finance modes in Lebanon

At the heart of Lebanon's capital, Beirut city center is an urban area thousands of years old, traditionally a focus of business, finance, government, culture and leisure. Its reconstruction constitutes one of the most ambitious urban revitalization projects of our time.

The North and South Souk phases are projected to end by the first semester of 2008.
The development involves several facilities and commercial areas, as informed to us by Dr. Salim Othman, Corporate Financial Officer of Solidere.
The amenities and commercial areas are:

a) Destined for RENTAL:
    - Cinemas x 8
    - Department store 15,000 m2 @ US$200 per m2. To be rented to a AAA anchor.
    - Multiuse Building 10,000 m2 @ US$210 per m2. Offices and second floor banks.
    - Restaurants 1200 m2 @ US$1,000 per m2. For branded restaurant.
    - Souk rental 45,000 m2 @ US$ 500$ per m2. 3 months rental deposit required.

b) Destined for SALE, as agreed with the Jewelers Association of Lebanon:

- Gold Souk total value of sales: US$50,000,000. Payment modality:
    - i. 25% down payment
    - ii. 75% financed by Solidere for 5 years @ 1 year Libor+250BPs.

SOLIDERE PHASE 1 AND 2 PROJECTED INCOME (US$ 000)-Unofficial data

Rental contracts income	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR10
Cinemas x 8	1,500	1,500	1,500	1,590	1,685	1,787	1,894	2,007	2,128	2,255
Department store 15,000@200$/m2	3,000	3,000	3,000	3,180	3,371	3,573	3,787	4,015	4,256	4,511
Multiuse Building 10,000 @ 210$/m2	2,100	2,100	2,100	2,226	2,360	2,501	2,651	2,810	2,979	3,158
Restaurants 1200@1,000$/m2	1,200	1,200	1,200	1,272	1,348	1,429	1,515	1,606	1,702	1,804
Souk rental 45,000@500$/m2	22,500	22,500	22,500	23,850	25,281	26,798	28,406	30,110	31,917	33,832
Rental Deposit on souks 3months	5625									
Total income from rent	**35,925**	**30,300**	**30,300**	**32,118**	**34,045**	**36,088**	**38,253**	**40,548**	**42,981**	**45,560**
sales income										
gold souk @50M 25%down 75% 5 years @libor+250BP	12,500	7,500	7,500	7,500	7,500	7,500				
Interest on souks sales Libor+250BP	0	2,073	1,555	1,037	518	0				
Total income from sales	**12,500**	**9,573**	**9,055**	**8,537**	**8,018**	**7,500**				
Gross total Income	**48,425**	**39,873**	**39,355**	**40,655**	**42,063**	**43,588**	**38,253**	**40,548**	**42,981**	**45,560**

Table 4-2 Unofficial Projected cash flow for Solidere Rental and sales of Souk Phase I and II- Estimates by the author.

The 2005 annual report of Solidere, published recently, includes the 2004 and 2005 statements of accounts, balance sheets and the auditors reports and notes. We will use a brief resume of the major accounts in order to illustrate our selected modes of finance, in Table 4-3.

Solider Balance Sheet

Dec.31	**2005**	**2004**
ASSETS	**US$ Million**	
Cash and bank balances	102	112
Prepayments and debit balances	22	16
Accounts receivables	273	211
investment in securities	10	4
properties held for development and sale	1521	1606
investment properties	160	159
investment in a joint venture	32	0
fixed assets	19	18
total ASSETS	**2139**	**2126**
LIABILITIES		
bank overdrafts	10	11
accounts payable	75	77
dividend payable	10	11
deferred revenues	66	61
deferred credits	4	36
loans from banks	129	234
total LIABILITIES	294	430
Shareholders equity	1845	1696
Total liabilities and equity	**2139**	**2126**

Table 4-3 Solidere Balance sheet 2004-2005. Source: Solidere Annual Report 2005

For our subsequent work concerning Solidere, we will adopt the 2005 balance sheet.

The first question that arises when trying to apply an Islamic mode of finance is: is the company in question (Solidere) Sharia compliant? Or, in other words, does the company pass the screening criteria agreed upon by Sharia scholars?

The screening conditions are mentioned in section 3.3.2 above. They are:

1. Exclude companies or stock undergoing any Haram activity: Pork, alcohol, pornography, insurance, tobacco, gaming or gambling and armament.

2. Exclude companies if Total Debt divided by Trailing 12-Month Average Market Capitalization is greater than or equal to 33%. (Note: Total Debt = Short-Term Debt + Current Portion of Long-Term Debt + Long-Term Debt).
3. Exclude companies if the sum of Cash and Interest Bearing Securities divided by Trailing 12-Month Average Market Capitalization is greater than or equal to 33%.
4. Exclude companies if Accounts Receivables divided by Total Assets is greater than or equal to 45%. (Note: Accounts Receivables = Current Receivables + Long-Term Receivables).

Table 4-4 below summarizes the financial screening ratios of Solidere.

Screening Ratios	2005	2004	Criteria
Debt Bearing= Debt/ Assets	**14%**	20%	*< 33.3%*
Interest bearing revenues/ Assets	**5%**	5%	*< 33.3%*
Accounts receivables/ Equity	**15%**	13%	*< 45%*

Table 4-4 Solidere financial screening ratios.

The financial screening criteria are met according to the table above and Solidere does not undergo any Haram activities. We can conclude that Solidere is a candidate for Islamic financial instruments and in the subsections below we will suggest some Islamic financial instruments that can be beneficial to Solidere as well as be attractive to local and foreign investors.

4.3.1 Solidere Murabaha Deposits

First instrument we suggest for Solidere is to invest their cash available in an Islamic Bank (IB) through Murabaha deposit. Currently, according to Table 4-3, the cash amount is US$102 Mn. The mechanism of Murabaha deposit is the following:

Solidere buys a commodity (London Metal Exchange: Aluminum, tin, copper, etc.), through its agent, the Islamic Bank, at spot price P from broker A (Hence Solidere uses its cash available) and sells it at deferred payment date at Spot + an agreed upon profit to the IB. The IB sells

immediately the commodity to Broker B, at spot price P. at settlement date, the IB will return to the client, Solidere, P+ profit. We note that this is a pure Sharia transaction, and neither parties is exposed to the commodity price volatility because both initial operations at day 1 are spot. The flowchart of the operation is as follows:

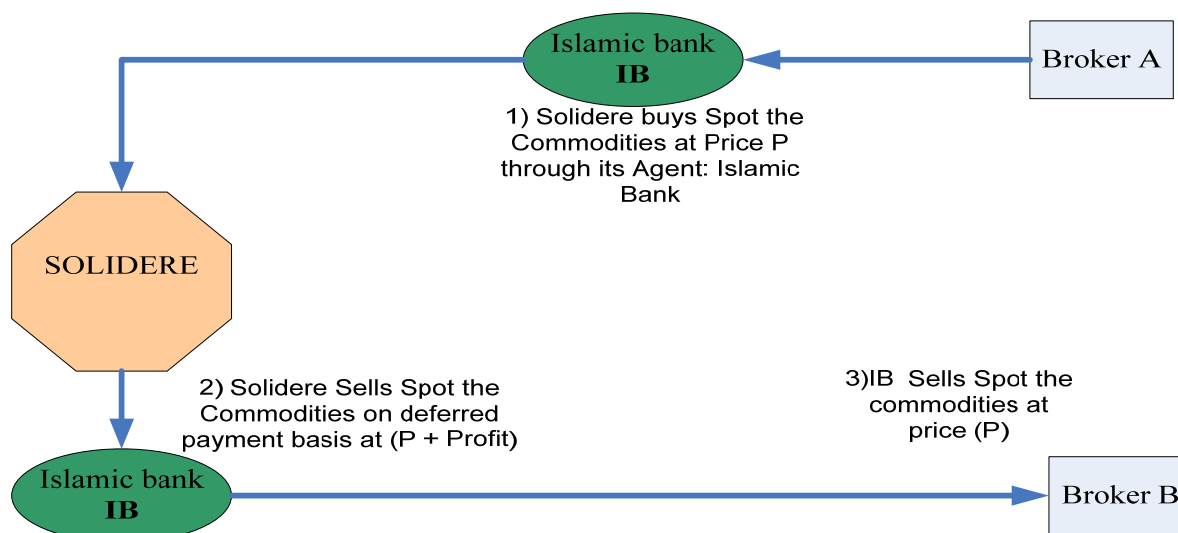



Figure 4-2 Solidere Murabaha deposit scheme

4.3.2 Solidere Sukuk al Musharaka.

Due to successful recent US$200Mn closing of the Dubai Metals Commodities center's "Gold Souk Sukuk", we would like to explore this structure for Solidere also. If we assume that Solidere needs US$200mn to finalize the Phase II of the Souk, we will build a Sukuk al Musharaka structure around this project, being the easiest mode of Islamic finance when a real estate project is involved.

Solidere will eventually enter into a Musharaka, or equity partnership participation and will share the profit/loss resulting from the project. Moreover, on a second parallel phase, the intermediary or SPV of this operation will receive funds from investors and will give in return an Islamic Bond or Sukuk based on the principal and the proceeds of the Musharaka, hence the denomination of Sukuk al Musharaka. Solidere will advance the land that it owns and where it needs to construct the project. We will assume hereafter that the total value of the project is

US$200Mn and that Solidere owns the land, as it is really the case. We anticipate therefore, from the Musharaka side of the instrument, that each investor entering in the Musharaka will receive a certain amount of Units or shares , proportional to his contribution. We can anticipate as well, from the Sukuk side of the instrument, that each Sukuk holder will receive proceeds for holding his titles, like the coupons in case of a conventional bond, and that at maturity of the instrument, the investors will have to receive the value of their principal. The management agent will be the Islamic bank IB.

The following are the main data involved in this project:

- Total value of project : US$200mn
- We will benchmark the Sukuk coupon payment with a fixed coupon of 8% per annum paid semi-annually, i.e. if the Sukuk issue is at US$200Mn, the coupons value will be US$8,000,000 each six months.
- Solider will participate in 10% in form of land, SPV will participate with 90% in form of Sukuk proceeds.
- Total value of operation: US$ Mn (200 / 0.9) = US$ 223Mn approximately rounded to the highest digit. Therefore the land from Solidere should be worth US$23 Mn and the SPV cash participation will be US$200Mn, needed to achieve the project.

Profit/loss distribution scheme:

	Residue as incentive	10%	90% cap US$8Mn	
Profit US$000	**IB manager**	**Solidere**	**SPV**	**SPV return**
5,000	0	500	4500	4.5%
8,900		900	8000	8%
10,000	1000	1000	8000	8%

Table 4-5Profit/loss distribution for a Sukuk Musharaka Solidere scheme.

It is observed that the profit for the SPV is capped at US$8.000.000 being the agreed 8% coupon value annually paid each 6 months. Solidere will always get 10% of the proceeds and the IB, being the manager of the operation will get the residue only when the cap of US$8Mn for

SPV is reached , i.e. when the profit is US$8Mn/ 0.9 = US$9Mn. The schematic representation of the profit/loss distribution is apparent in the following graph:

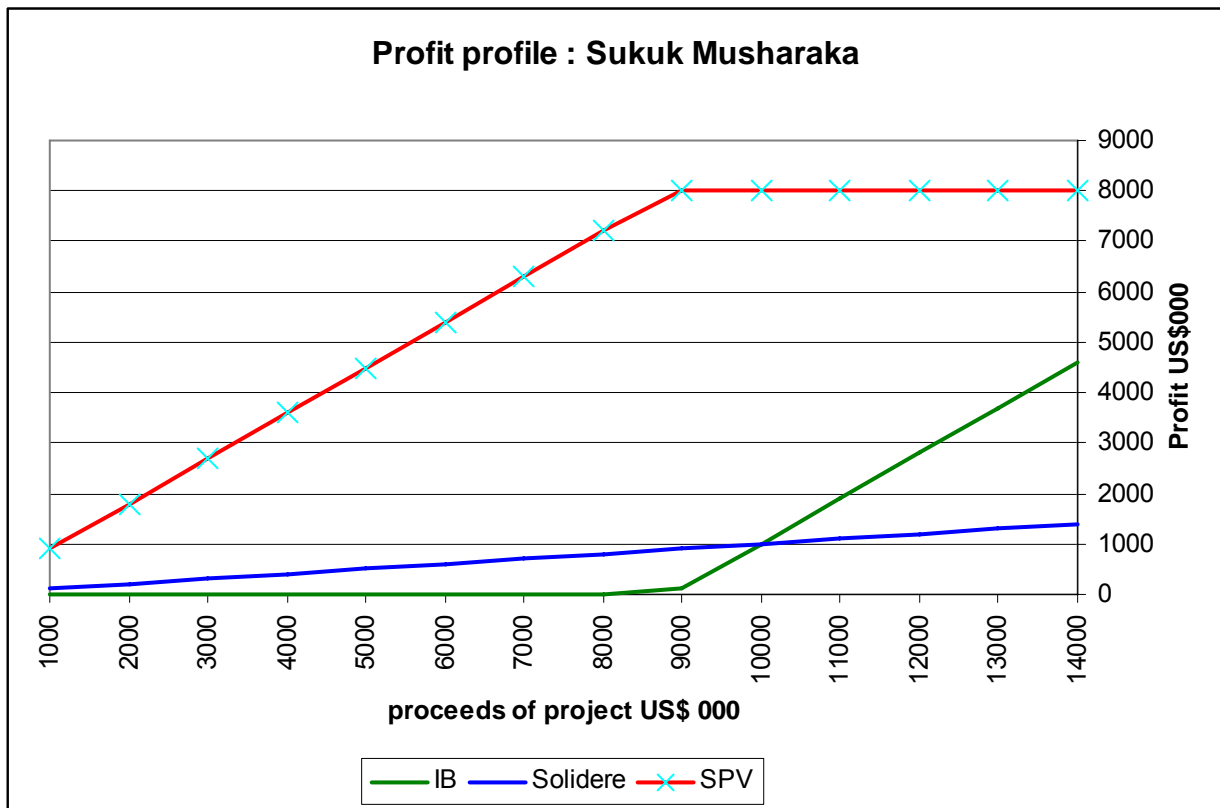



Figure 4-3 Sukuk al Musharaka profit/Loss profile for IB, Solidere and the IB.

It is interesting to analyze the profit profile of each party involved:

- Solidere: The curve is a straight line equal to 0.1 x profit. It is assimilated to a forward contract on the profits of the project at 10%.
- Islamic bank (IB) as a manager: The curve is assimilated to a long Call option with exercise price US$ 9Mn being equal to cap of Sukuk coupon per 6months divided by 90% or CAP 6months/ 0.9.
- SPV: The riskiest profile curve because it is assimilated to a short Put option. It is actually a sale of a put option with exercise price at US$9Mn.

The couple of risk-revenue being always present in any investment scheme, and realizing that the risk is bigger for the SPV and hence for the Sukuk purchasers i.e. the investors, we should expect that the investors will have a higher expected return then Solidere, whose risk is substantially lower. In fact, knowing that Solidere invests US$23Mn its average expected return is around 3.4% whereas the average expected return for the SPV is 5.7% reflecting remuneration for a higher risk, as shown in table 4.6 below.

Return profile		
profit	**SPV**	**Solidere**
1000	0.9%	0.5%
2000	1.8%	0.9%
3000	2.7%	1.4%
4000	3.6%	1.8%
5000	4.5%	2.3%
6000	5.4%	2.7%
7000	6.3%	3.2%
8000	7.2%	3.6%
9000	8.0%	4.1%
10000	8.0%	4.5%
11000	8.0%	5.0%
12000	8.0%	5.5%
13000	8.0%	5.9%
14000	8.0%	6.4%
Average	**5.7%**	**3.4%**

Table 4-6 Expected yearly rate of return for Solidere and the SPV in the Sukuk al Musharaka scheme.

In parallel, the drafted documentation shall provide that on every payment date of the profits, e.g. every 6 months, the SPV will have the possibility to exercise a sale option of part of its units, for a value of US$ 8,000,000 in favor of the Islamic Bank, therefore providing the SPV, in any of those three cases, with enough cash to pay the coupon to the investors. At maturity, Solidere shall be committed to buy the remaining units of the SPV for a value of US$ 208Mn (i.e. equivalent to the payment of the nominal value of the Sukuk issue plus payment of the last coupon: US$200+US$8 Mn).

At liquidation or completion date Solidere will buy back the Units or shares of the SPV, and the proceeds of this sale will be used by the SPV to pay back the principal of the Sukuks sold to the investors at Day 1.

The IB, in its quality of Management Agent, shall be in charge of distributing the proceeds received through the Musharaka to the Musharik (units holders) and shall receive the potential surplus as performance fees. The IB, under a Purchase Undertaking agreement, shall have the possibility, when needed, to buy part of SPV's Units.

The block diagram of the Sukuk al Musharaka for Solidere is depicted in Figure 4-4:

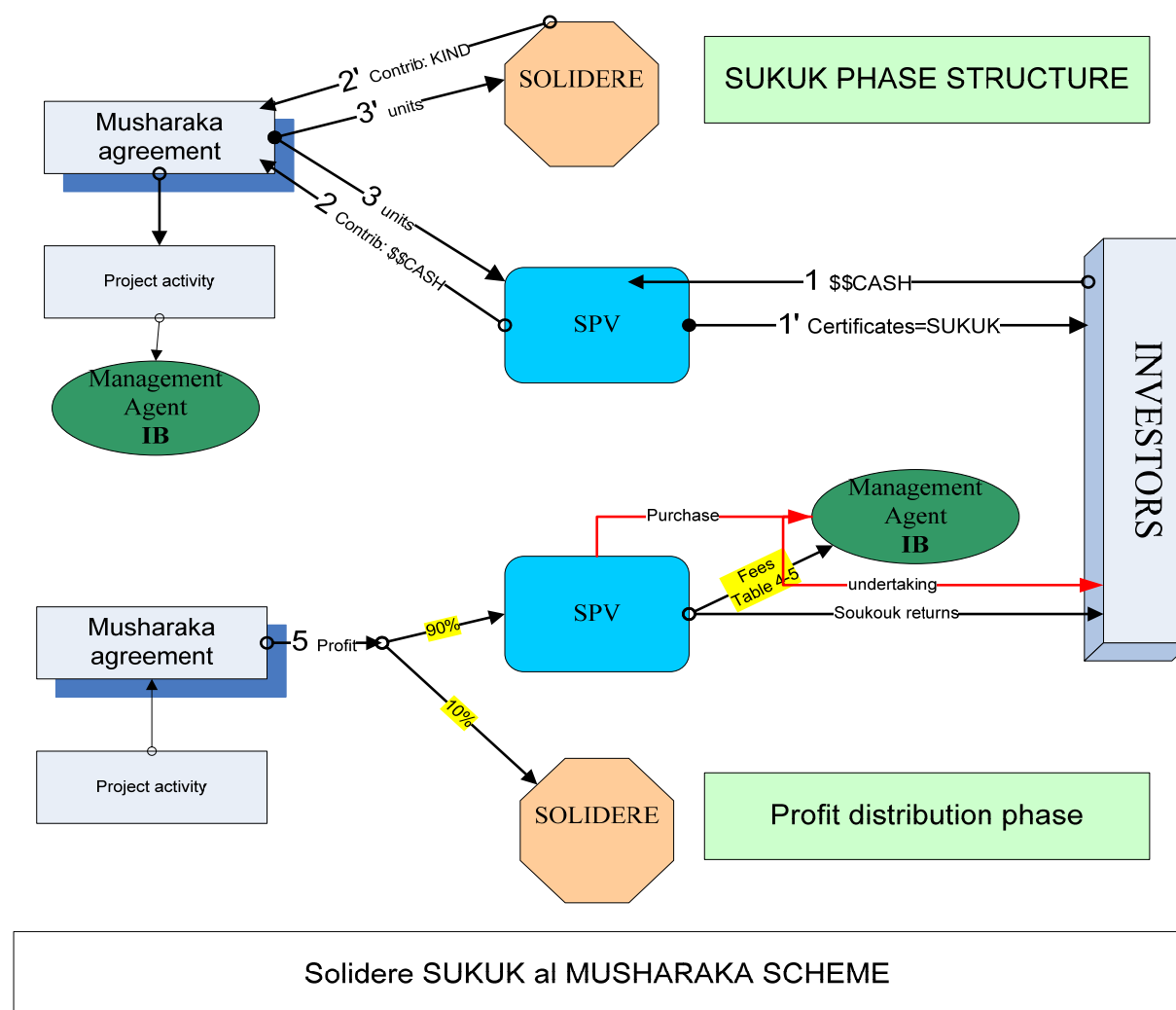



Figure 4-4 Solidere Sukuk al Musharaka scheme.

Alternatively, and in the same scope of funding its US$200Mn project, and referring to the cash inflow projection depicted in Table 4-2 above, Solidere is going to receive cash income from

leasing the amenities and areas constructed. Solidere can issue Sukuk Ijara ($150M) to fund its project, and can issue Ijara Muntahia Bitamlik to the Gold Souk final purchaser ($50M) for a total issuance value of $200M. The Solidere Sukuk Ijara issuance of US$150Mn is as follows:

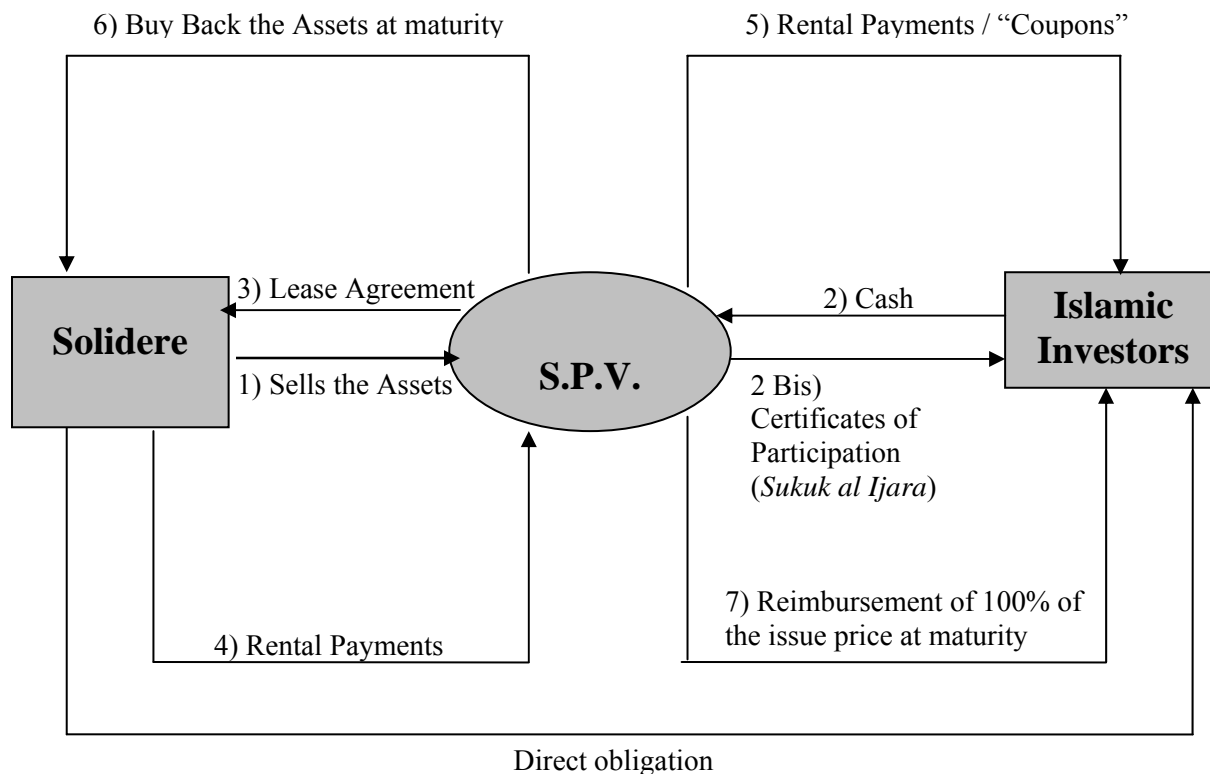



Figure 4-5 Solidere Sukuk al Ijara to fund Phase II of Souk. Adapted from J.M.Riegel "Sukuk al Ijara", ESA 2005.

4.3.3 Solidere Securitization.

This form of Islamic structure meets various conditions:

It is asset-backed (at least for 51% of the outstanding issue),

It complies with the principles of Risk-Sharing under Sharia law as opposed to the principle of time value for money (Interest),

The Return on the investment will have the same form as for conventional securitizations, i.e. it will reflect the exposure for the Investors on the securitized portfolio.

Analyzing Solidere annual report 2005, and the statement of accounts we find that a value of US$282,568,976 represents Accounts and Notes Receivables. Referring to note#6 of the annexed auditors report, we extract the following table:

Accounts and notes receivables (US$ Mn)							
2005	2006	2007	2008	2009	2010	2011	Total
0	83	79	43	34	23	15	277
Note: excluding Doubtful and overdue balances. Source: Note#6 P.85 of Solidere 2005 annual report							

Table 4-7 Solidere Accounts receivables. Annual report 2005

We will assume, referring to this table above, a mismatch between liabilities and assets and we will recommend an Islamic Securitization of these receivables. Note that it is mentioned that the above notes receivables consist mainly of sales transactions of real estate assets backed by a first degree mortgage. Hence we will consider this operation as Asset backed Securitization by including in the transaction a tangible real asset amounting to 51% of the total transaction value: US$Mn (277/0.49 -277) = US$288Mn

In this instrument Solider will act as the Seller and service agent for the contemplated assets, and the Islamic Bank IB will act as the arranging bank.

The funding of the transaction will be ensured through the issuance of Sukuk. The Sukuk represent a proportional beneficial ownership in the underlying assets and will be remunerated with a periodic return (annual or semi annual) corresponding top the cash flow generated from these same assets.

A restricted Special Purpose Vehicle as a Mudaraba , will be formed with the IB as the manager or Mudarib. It will be domiciled in a tax efficient jurisdiction like Jersey Island. The SPV will enter into a Pass-Through Agreement with the Solidere under which the SPV will purchase all "risks and rewards" of the Tangible Assets and the receivables. As per this Pass Through Agreement, the SPV will be deemed as the owner of the contemplated Assets, therefore entitled to all the Cash Flows of the Murabaha. The Finance Company SPV shall also, as the owner, bear the consequences of losing its investment, in case of default or destruction of the underlying Assets.

A restricted Special Purpose Vehicle (the "Mudaraba") will be formed with the Arranging Bank as the Mudarib (manager). This Mudaraba will be domiciled in a tax efficient jurisdiction (for example in Jersey).

The exposure for Sukuk Holders, in the case of Securitization deal, is on the portfolio as opposed to Solidere itself in the case of a Debt Capital Market Sukuk issue, i.e. the return for the Sukuk Holder is based on the quality and performance of the Portfolio and the Sukuk Holders are entitled to a part of margin on the Portfolio and not a "coupon" from Solidere. In case no default occurs on the portfolio, the margin on such Underlying shall be greater than the return on the Sukuk; therefore, this excess shall be returned to Solidere, acting as Servicer, in the form of a Performance Fee.

The Sukuk will be issued in different tranches that replicate the breakdown of receivables as shown in Table 4-7 above, or Solidere has the ability to replenish the SPV with newly originated receivables.

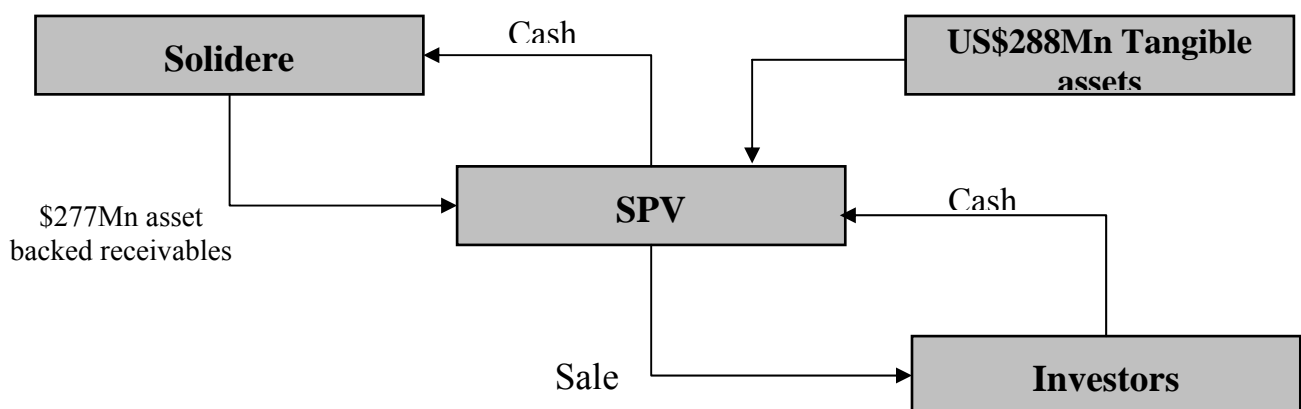
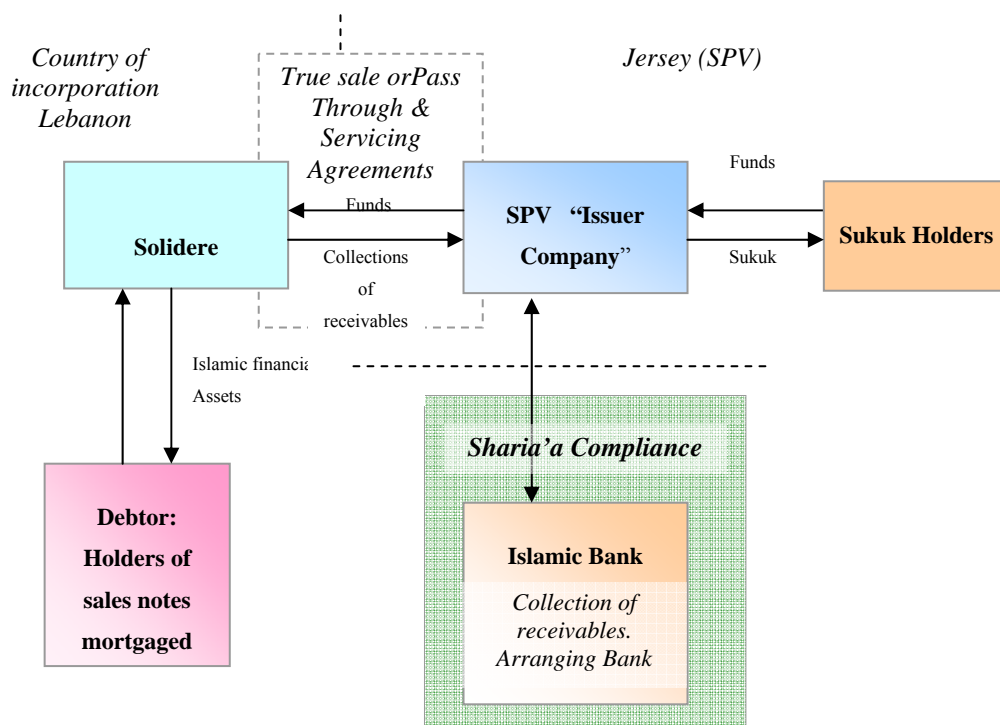
Figure 4-6 below illustrates the block diagram of this transaction

……………………..

Figure 4-6 Solidere Islamic Securitization scheme. Adapted from J.M.Riegel "Islamic asset Securitization" ESA, 2005

4.3.4 Solidere profit rate swap.

Referring to Solidere annual report 2005, pages 86-87, Note#7 : "*Investments in securities*", we note that Solidere has purchased several investments in capital guaranteed structured products, issued by foreign financial institutions. Coupon rates depend on certain conditions being satisfied, depending on each instrument, but mainly is related to the Libor rate, and hence the yielded income is variable. The total amount of securities held by Solidere, at the closing date of the annual 2005 report is : US$19,990,500 in book value. The Net value is US$9,853,770 and the difference being the Leverage with sell-off right being US$ 10,136,730. The auditor report page 86 mentions : " *This portfolio has yielded income of 9% in 2005.*"

It is not mentioned whether Solider hedges the variable income from its securities investment with a conventional interest rate swap. In our effort to suggest Islamic financial investments in Lebanon, we see that applying a Profit Rate Exchange instrument to hedge a variable income cash flow would have the following advantages:

- This is an innovative instrument and it will bestow a notorious visibility on the IB that will apply it in Lebanon and in the region.
- This is a profit rate risk mitigation instrument, accepted by Sharia.
- It is based on Murabaha deposits and revolving Murabaha, both authorized by BDL.

For the illustrative purpose of this section we will assume that Solidere has acquired Sukuk instead of conventional bonds, receiving a variable return on Sukuk equivalent to Libor +1% yearly. It should be mentioned however, that in the case where the portfolio includes various Sukuk , at various maturities and various yield, the hedging strategy using the Profit rate or Murabaha swap discussed below, should be applied to each Sukuk. In other words, for a certain number of different Sukuks held in the portfolio, the same number of swap operations should be contracted.

A conventional interest rate swap IRS is a contract between two parties to exchange interest payments on a defined principal basis for a fixed period of time. It does not involve the exchange of notional or principal, and both parties can net out the result of the exchange of payment at each payment date. This operation is booked off-balance sheet for both parties. In an IRS one party pays a fixed amount and the other pays a variable amount.

In Islamic Finance, interest payments are Riba and are not Sharia complaint. Yet, as illustrated below, the Murabaha deposit and revolving Murabaha can be used to simulate the conventional IRS.

Step 1- Cash flow analysis of floating rate Sukuk, notional US$1,000,000 at 1YL[58]+1%.

cash flow simulation of a US$1Mn 5 Y Sukuk @ 1YL +1%					
	Y1	Y2	Y3	Y4	Y5
Libor 1Y-(simulation)	5.75%	5.87%	5.16%	5.00%	4.85%
Libor +1%	6.85%	6.97%	6.26%	6.10%	5.95%
Yield on US$1Mn	68500	69700	62600	61000	59500
It is assumed that Libor values in table reflect the maturity date of the coupon payment at end of year					

Table 4-8 cash flow simulation of a 1US$Mn Sukuk @ 1YL+1%

The Sukuk holder, Solidere in this case, receives a variable yield on his Sukuk depending on the benchmark reference, here the 1 Year Libor rate, being at 5.75% on the 26th June 2006.

Hence Solidere will enter in a 1 year[59] revolving Murabaha with the Islamic bank IB, with the following characteristics

1 Year REVOLVING Murabaha	
Seller	Solidere
Buyer	IB
Cost	US$1,000,000 the notional
Profit required	US$68,500
Selling price	US$1,068,500
Payment terms	US$1,000,000 + US$68,500 1 single payment

Table 4-9 1 year revolving Murabaha, the floating Leg of the Profit rate exchange Instrument.

This Revolving Murabaha will be renewed every life cycle of payment, in this case every 1 year, at the maturity date of the first Murabaha and henceforth.

The Islamic Bank, the buyer of the revolving Murabaha, will have to offset his cash flow by selling to the client, Solidere, a fixed leg Term Murabaha of 5 years in a fixed revenue

[58] 1YL stands for 1 year Libor. It will be assumed to be 5.75% (quoted at 26 June 2006).

[59] Solidere will enter in a 1 year revolving Murabaha with the IB based on the 1 year yield term of payment. Had the Sukuk been at 1YL+1% semiannual payments, Solidere will enter in a 6 months revolving Murabaha with IB.

benchmarked profit rate. We assume, for illustration, that the IB will sell or deposit with Solidere, a fixed term Murabaha of 5 years at the 1YLibor + 50bps of today i.e. at 5.75%+.5%=6.25% fixed during the life time of the Murabaha deposit. The cash flow will look like the following table:

Cash flow of a Murabaha deposit with Solider. Notional US$1Mn at 6.25% fixed, yearly payment					
	Y1	Y2	Y3	Y4	Y5
Yield	6.25%	6.25%	6.25%	6.25%	6.25%
Yield on US$1Mn	62500	62500	62500	62500	62500

Table 4-10 Cash flow of a Murabaha deposit with Solider. Notional US$1Mn at 6.25% fixed, yearly payment

The briefing of the operation is as follows:

5 Year Murabaha deposit	
Seller	IB
Buyer	Solidere
Cost	US$1,000,000 the notional
Profit required	US$ 62,500
Selling price	US$1,062,500
Payment terms	US$1,000,000 + US$62,500. every year end

Table 4-11 5 year Murabaha deposit at fixed rate of 6.25%

The netting and the resulting cash flow is as per the table below:

Net cash flow after netting between Solidere and IB					
	Y1	Y2	Y3	Y4	Y5
Solidere pays to IB	1,068,500	1,069,700	1,062,600	1,061,000	1,059,500
IB pays to Solidere	1,062,500	1,062,500	1,062,500	1,062,500	1,062,500
Net cash flow to Solidere	**-6000**	**-7200**	**-100**	**1500**	**3000**

Table 4-12 based on a hypothetical 1Year Libor values at y1-y5, cash flow netting table for a 5 year Profit rate exchange Islamic Instrument, the notional being at US$1Mn in both operations.

Please note that the notional of US$1Mn is to be exchanged in each term payment in order to reenter in the Revolving Murabaha.

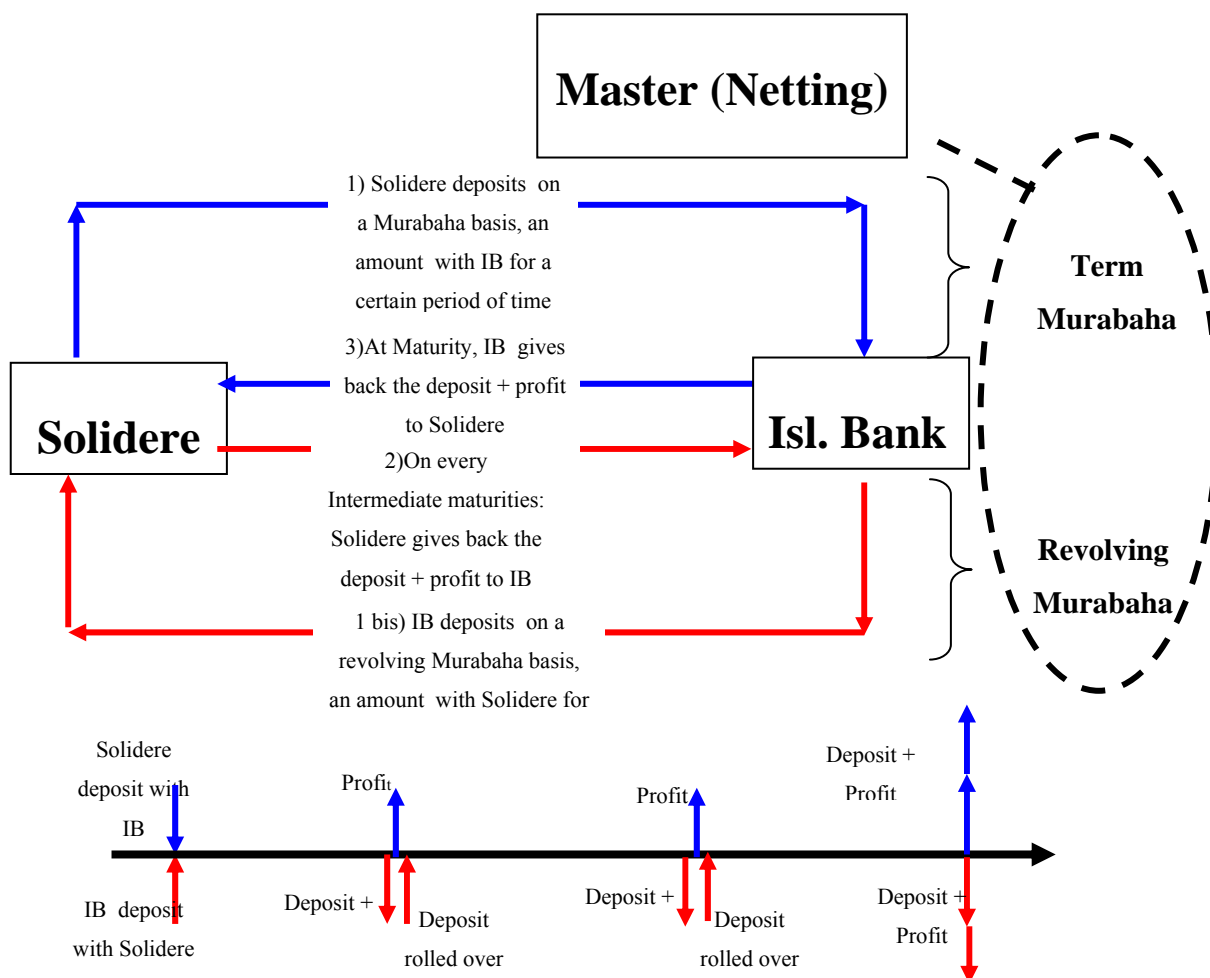



Figure 4-7 Structure diagram of Solider Profit rate exchange instrument. Source: Adapted from J.M. Riegel, "Profit rate exchange", ESA 2005.

(Arrows lengths not to scale with values exchanged).

This structure presents several challenges notably regarding the fact that, according to Sharia, it is not allowed to condition one contract with the other. The same happens with Salam and parallel Salam , when the fact that the bank enters in a Salam contract with a commodity provider, can enter in a parallel Salam with an end purchaser, but cannot condition the execution of the selling commodity to the end buyer with the successful receipt of the commodity, product of the first Salam. Similarly, in the case of the Profit Rate Exchange instrument, if Solidere cancels the revolving Murabaha deposit agreement after 2 periods (2 years) the term deposit

Murabaha will remain valid. Hence the risk undertaking such a parallel operation not threaded with a condition of the existence of the other.

4.4 Privatizing Public Companies: an Islamic Financial approach.

"As a platform to promote greater cooperation among Muslim countries and further promote IIFM, a proposal that can be explored is the creation of an Islamic universal bond, structured similar to the universally-accepted asset-backed Ijara Sukuk. Under this proposal, interested countries and selected organizations could be invited, where each country sells its Assets to an SPV, which in turn would lease back the Assets to the country. Proceeds could then be transferred to the participating country for the general purpose of socio-economic development. This could be an avenue for countries that have not secured stronger ratings to get more competitive funding. Indeed, regional and multilateral entities would be well positioned to explore the viability of this proposal."[60]

This is a global vision stated by H.E. Dr Akhatar Aziz, Governer of Malaysia central bank, promoting a large pool of funds to fuel cross border Sukuk, based and linked to Public owned company throughout the Islamic word.

The privatization issue in Lebanon has been on the fore front of political and economic discussion for the past 12 years.

Some discussions have been going on in the country lately on the urgent need to privatize some public companies like EDL (Electricité du Liban), the land and cellular companies , the Rafik Hariri International Airport, the port of Beirut, to name some major companies. The newly launched economic reform project we mentioned earlier, relies on privatizing these companies to lower the debt/GDP ration around 130%. Needless to say, the issue is not economic only and many political webs are weaving around it. Our aim is not to decide whether the privatization concept is politically right or wrong. We will try to demonstrate that the government can use an

Islamic Financial instrument to attract funds through a publicly owned company still keeping the ownership of its assets. We will not focus on one company in particular, but we will state hereafter the following premises to be able to apply the structure of Sukuk al Intifah we discussed below:

i. The company does not undergo any Sharia non-compliant activity, like alcohol selling or producing, gambling, pork and armament.

ii. The company is evaluated at market price, and obeys the Sharia criteria ratios we mentioned earlier. (See Solidere case above)

iii. The company produces an income for the sale of its products and services.

iv. The privatization process will not transfer the ownership its real assets legally to any entity. We mention this as a reminder of the political discussion around the privatization issue at large.

The instrument we will consider first will be the issuance of Sukuk al Intifah. In section 4.4.3 we will focus on a more direct privatization approach, the Musharaka. As we will see in the discussion below, Sukuk al Intifah is used to attract investors funds but is not a purely privatizing instrument.

4.4.1 Sukuk al Intifah.

This structure is very similar to Sukuk al Ijara (see Figure 4-5 page 76) with a major difference: No legal transfer of the tangible assets is carried out. Indeed, Intifah in Arabic means benefit or usufruct, in the sense that in this instrument Intifah means the right on the usufruct or the beneficial ownership of the Selected Tangible Assets.

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[60] Aziz, Zeti Akhtar (2004), governor of the Central Bank of Malaysia. “Towards creating an Islamic Financial system as an integral part of the international Financial System-Strategies and Challenge” *Asian Islamic Banking & Finance Summit*, Kuala Lumpur .

Many sovereign Sukuk al Intifah issues have been successful lately like:

- Bahrain Monetary Agency: US$250,000,000 Trust Certificates due 2009
- Pakistan (Islamic Republic) : US$600,000,000 Trust Certificate due 2010

The issuance by the government of Lebanon, of Sukuk al Intifah, backed by EDL for example will benefit the country in many aspects:

a- It will allow the country to explore untapped investors eager to invest in Sharia compliant instrument at a comparable return over conventional alternatives.

b- A Sukuk al Intifah issuance in Lebanon will present a geographical diversification to the investor society whose investments are concentrated in the GCC and in Malaysia in a greater percentage.

c- The issuing Islamic Bank IB will gain a visibility in the region and in Lebanon as being the pioneer of such an operation in Lebanon.

d- The structure of Sukuk al Intifah will lay to rest the uncomfortable Lebanese citizens feeling a certain degradation of the sovereign assets: EDL will remain at the end in the sole possession of the Lebanese government.

Sukuk al Intifah is an instrument or a security (Sukuk) representing beneficial ownership of the underlying Ijara Sub-Lease Contract between the Mudaraba (i.e. the SPV) and the ultimate issuer. Periodic returns payable to Sukuk Holders are sourced from the profits earned on the underlying Ijara Sub-Lease Contract (i.e. rentals). Such returns are paid on pre-determined dates, usually on a semi-annual or a quarterly basis.

Step 1- The government of Lebanon establishes an SPV as a Mudaraba, with the EDL as the sole shareholder. An Islamic bank IB will be appointed as the manager of the SPV or the Mudarib. This SPV can be domiciliated in Lebanon as an offshore company, which is contemplated by the Lebanese laws.

Step 2- the SPV as the Lessee and the EDL as a Lessor enter into an IJARA head lease agreement. In this agreement the Lessee, or SPV, pays to the Lessor EDL the advance rental corresponding in fact to the nominal value of the issue. The SPV's source of funds will be the issuance of Sukuk al Intifah sold to the investors. The Ijara head lease agreement allows the SPV the full usufruct (Intifah) of the tangible assets (EDL) including the right to sub-lease them. In fact the SPV (lessor now) will enter then in a sub-lease agreement with the Lessee EDL. The SPV is acting as a trustee in respect of the trust of EDL assets for the benefit of the Sukuk holders. To be noted that EDL, shall remain the legal owner of the tangible assets of EDL.

Step 3- SPV issues Sukuk al Intifah to raise funds, at nominal value, committing itself to pay a pre-determined periodic distribution amount to the Sukuk holders. These proceeds are used to pay the Lessor EDL the advance rental under the head lease agreement.

EDL being both the legal owner Lessor and final Lessee is responsible for Major and ordinary maintenance of the assets. The Sukuk holders have no obligations and hence no interference with the assets maintenance and management.

Step 4- Redemption of the Sukuk al Intifah. At maturity, the Sukuk holder will receive the last periodic distribution payment (coupon) and the principal.

- The rental on the Ijara sub-lease could be fixed in advance at launch replicating a fixed rate coupon.
- The rental could, as an alternative option, be reset on a regular basis, replicating a floating rate coupon.
- The holders of the Sukuk al Intifah can trade them in a secondary market, at market price.

- 3 key documentations are required:
  - The Ijara Head lease between EDL as Lessor and SPV as Lessee
  - The Ijara sub Lease between SPV as Lessor and EDL as Lessee.
  - The declaration of trust, EDL as a trustee.

The structure diagram is shown in Figure 4-8:
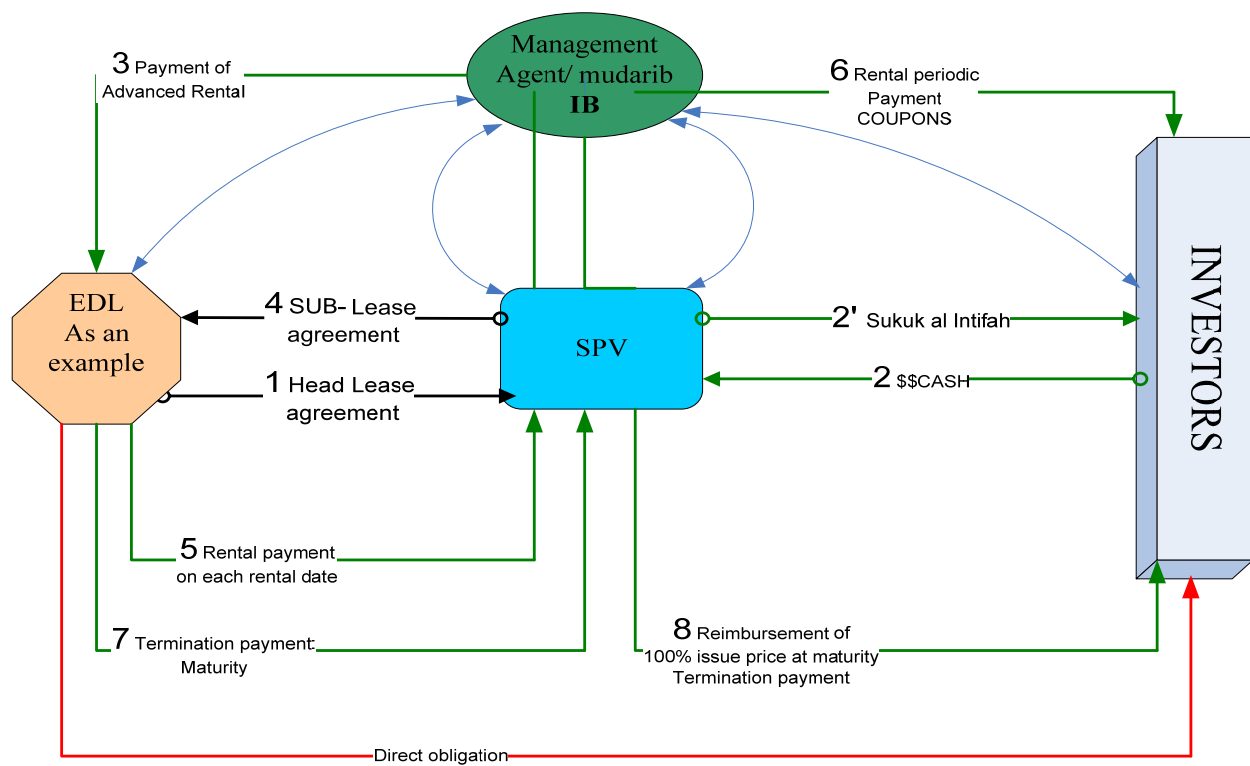
Figure 4-8 Sukuk al Intifah. EDL as an example.

4.4.2 EDL privatization: some practical comments

As seen in section 4.4.1 above, this is an illustration of a public company based Sukuk scheme taking EDL as an example. Far from being theoretical, we wish to mention the following:

1. In 2002 the Lebanese government commissioned BNP Paribas to prepare a plan for privatizing EDL, a string to Paris II reform plan.
2. The plan called for splitting EDL into 3 separate companies
    a. Generation company
    b. Transmission company
    c. Distribution company
3. The plan considered offering 40% of the shares of each of these 3 companies to investors.
4. We believe that EDL can use the above structure of Sukuk al Intifah as follows:
    a. For the Generation company using the Sukuk al Intifah structure. This will allow a fair amount of cash to be used to modernize the infrastructure of the generating machines.
    b. Securitize the collecting end of the system by leaving the distribution network owned by the Government. EDL has a substantial amount of receivables in the form of back log invoices . EDL can use the distribution network as a tangible asset at 51% and the remaining 49% from receivables to make up for a 100% securitization pool made of Murabaha and real assets. The proceeds of this securitization will be used to modernize the measuring meters network, link them to a network collection software and, above all, improve the service quality.
    c. The transmission company can issue Sukuk al Ijara, self renting the transmission network itself from an SPV owned by EDL and issuing Sukuk al Ijara. The income will remedy the mismatch of assets and liabilities of EDL and will normalize the delivery and purchase of the fuel to maintain the generation stream normal and uninterrupted.

d. If the Ijara sub lease agreement states floating rate payments, EDL can use the structure of Profit Rate exchange to hedge against acute variations of the benchmark rate used. This structured was discussed in section 4.3.4 above.

In a nutshell, Islamic Sukuk al Intifah scheme will ensure an inflow of foreign investors cash through the Sukuk issuance, will normalize the mismatch of assets and liabilities of EDL and will keep the company in the hands of the government, as discussed earlier, a much coveted political issue in Lebanon. **Yet, a question arises: is this form a real privatization?**

In other words, if privatization is actually concerned about the efficient governance of a publicly owned company , will Sukuk al Intifah ensure that an independent body of governance and administration be involved in making of EDL an efficiently run and managed company?

Clearly, the structure of Sukuk al Intifah does not involve a third party managing the day-to-day operation of EDL, and hence the argument against this instrument being a real privatization scheme prevails.

A complete privatization process that involves a third party management expertise will need to rely on a **"plain vanilla" Musharaka agreement**, or, in case of a pre-agreed upon exit strategy, a Sukuk al Musharaka structure, discussed earlier in Solidere case. Musharaka privatization plan is discussed in section 4.4.3 below.

What applies to EDL could be projected to the Land and Cellular telephony companies, MEA, the port of Beirut and the Rafik Hariri international airport, among other utility and services companies.

4.4.3 Musharaka: a privatizing approach.

In principle, a Musharaka[61] is a partnership between two or more parties, bound by a contract, to work together by the capital each contributes in condition of dividing the accruing revenues between them (Khoja Et al, 2002). The important characteristics of a Musharaka are:

1. Partnership in capital: Each party participates in the Capital whether it is in form of assets, cash, expertise or labor.
2. Partnership in work, management and decisions where the right of ownership and decision making remains to each partner.
3. Partnership in the results of the operation whether it is profit or loss.
4. The continuity in the partnership, usually medium to long terms.
5. Two modes of Musharaka:
    a. Permanent Musharaka.
    b. Decreasing Musharaka, or Musharaka Mutanaqisa.

It is interesting to explore the characteristics of both modes of Musharaka, to discuss later what would be the best method for Privatizing public companies in Lebanon.

It is important to note that in both modes of Musharaka, the partners advance cash or properties in the form of real assets, evaluated at a percentage of the shares of the company. This share allows the partners to share the profit/loss in a prorate of their participation[62], agreed upon in writing in the partnership contract. The difference between both modes resides basically in the exit strategies of one or more partners. This is shown in the following Table 4-13:

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[61] Khoja ,Ezzedine Mohd and Abou Ghudda, Abdel Suttar (2002), *Instruments of Islamic investment,* Al Baraka Islamic Bank, Research and development Department. Ch.III, PP 87 -

[62] Sharia stipulates that the profit is shared according to a pre-agreed upon percentage, in writing, which can be different from the percentage of equity shares held. Losses are assumed as a prorate of the % of equity shares.

Modes of Musharaka								
	Y1	**Y2**	**Y3**	**Y4**	**Y5**	**Y6**	**Y7**	**..Yn**
Permanent Musharaka								
Exit strategy	**Long-term partnership. Eventual offer of sales/purchase of shares at (C/ V1) x Vn, but non-binding**							
Value of company	V1	V2	V3	V4	V5	V6	V7	Vn
Capital advanced	C	0	0	0	0	0	0	0
% shares	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1
% P/L [63]	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1
Diminishing Musharaka: Musharaka Mutanaqisa Muntahia bi Istirja'								
Exit strategy	**agreement in a separate contract for sale of shares in year "n"**							
Value of company	V1	V2	V3	V4	V5	V6	V7	Vn
Capital advanced	C	0	0	0	0	0	0	0
% shares	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1
% P/L	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1
								Binding transfer
Diminishing Musharaka: Musharaka Mutanaqisa Mode 1								
Exit strategy	**investor keeps an additional % of P/L = a% until covering payment of principal**							
Value of company	V1	V2	V3	V4	V5	V6	V7	Vn
Capital advanced	C	C- aPL	C- 2aPL	C- 3aPL	C- 4aPL	C- 5aPL	C- 6aPL	C- (n-1)aPL
% shares	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1
% P/L	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1
accrued % of PL	a+ C/V1	a+ C/V1	a + C/V1	a + C/V1	a + C/V1	a + C/V1	a + C/V1	PL xΣa_{n-1} =C
Diminishing Musharaka: Musharaka Mutanaqisa Mode 2								
Exit strategy	**Investor sells every year b% of his shares to owner until he exits**							
Value of company	V1	V2	V3	V4	V5	V6	V7	Vn
Capital advanced	C	C(1-b)	C(1-2b)	C(1-3b)	C(1-4b)	C(1-5b)	C(1-6b)	C(1-nb)= 0
% shares	C / V1	C /V1 -b	C / V1 -2b	C / V1 -3b	C / V1 -4b	C / V1 -5b	C / V1 -6b	C / V1 -(n-1)b
% P/L	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1	C / V1
accrued% of PL	C / V1	C /V1 -b	C / V1 -2b	C / V1 -3b	C / V1 -4b	C / V1 -5b	C / V1 -6b	C / V1 -(n-1)b

Table 4-13 Permanent and Diminishing Musharaka mode of Finance.

The table above shows clearly that, in accordance with the political wish vis-à-vis the issue of privatizing public companies in Lebanon, the Diminishing Musharaka mode will allow the government to regain control and ownership of the asset privatized after a certain period of "N"

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[63] This is a special case where profit = C/V. in general is can agreed upon to be different.

years. The rationale behind dealing with the subject of privatization in a cautious manner from one side, and with a detailed financial engineering insight from the other, rests on the following:

1. Due to the interweaved socio-confessional aspect of the Lebanese society, it is imperative to be able to present an instrument which is tangent to the boundaries of a Sharia compliant instrument, to attract Sharia oriented investors and tangent to the boundary of a conventional and legally accepted instrument and contract covered by the Lebanese Code of contracts and obligations. This feature quenches confessional biased minds. We believe that Lebanon is, once again, a laboratory for exploring the confines of the boundaries of Islamic Finance in a multi-confessional society, presenting the market with an Islamic Financial instrument accepted by all currents of thoughts and believes.
2. The instrument of Diminished Musharaka, to privatize publicly owned companies, meets the expectations of the government in ensuring the return of the shares sold after a certain period of time. A similar conventional instrument exits, namely a stock with repurchase or call option. The major difference between the conventional and the Islamic instrument we suggest is that, aside the Sharia compliance issue, the Islamic instrument provides a Profit and Loss sharing scheme which is, in essence, an incentive to the government and the parliament to consider privatizing as a whole, as a viable alternative.
3. The fact that the investors are shareholders of the newly privatized company implies that they are invited to assume their function of management and governance. It is not a secret that a major reason for the decline of the profits and feasibility of the Public companies is the management efficiency and sound governance. On the other hand, ensuring a management grip to the shareholder will diminish their risk. The experience in privatization in Lebanon has shown that the companies improve their Internal Rate of return, IRR, and the ROI once they pass to the hand s of private sector. Port of Beirut docks, privatized a few years ago, is a living proof of this statement. That is why the government is considering privatizing the loading and unloading stations and the transit cross-docking stations in Port of Beirut.

The Diminishing Musharaka scheme operates as follows:

1. An SPV is established, in an offshore tax friendly jurisdiction.
2. EDL transfers in sales the amount of shares it wishes to privatize, representing real assets.
3. The Islamic Bank, acting as an arranger and manager of the flow of funds, representing the investors .(Mudarib)
4. Investors buy shares of the SPV, reflecting in a percentage of shares of EDL. They will also participate actively in management of EDL and in its board of directors.
5. Each year, the profits of the SPV, reflecting a % of profit of the shares of EDL owned by the SPV are distributed at a prorate of the number of shares.
6. Each year, and as per the diminishing ownership agreement, EDL buys back form the SPV a certain amount of its shares, that the SPV buys back from the investors. IB is the arranger of this operation.
7. The Profit and loss sharing for the next year , will reflect the new shares percentage of ownership after the last purchase of a fraction of the same by EDL.
8. The process continues until SPV buys back all the shares it emitted, and returns them to EDL. EDL will repurchase its assets sold to the SPV and will remain owned by its initial owner: the government.

The Sharia requires the strict observance of these particular rules related to Diminishing Musharaka[64]:

a. It is a condition in the decreasing or diminishing Musharaka that it shall not be a mere loan financing operation, but there must be real determination to

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[64] Khoja ,Ezzedine Mohd (2002), *Instruments of Islamic investment,* Al Baraka Islamic Bank, Research and development Department. p106.

participate actively and that all the parties shall share the profit or loss during the period of the partnership.

b. It is a condition that the investors must completely own their shares in this partnership and must have their complete right in management, disposal, and decision-making processes.

c. It is permissible to the investors to proffer a promise to sell back their shares to the issuing company, if the issuing company pays the price value of these shares. The sale must be concluded as a separate deal with no connection to the initial contract with the issuing company.

4.5 Special projects and infrastructure renewal: an Islamic financial approach.

Lebanon is relying entirely on foreign and internal debt to finance its infrastructure projects. The long years of war left the country with a destroyed infrastructure and a heavy deficit. The scope of this section of the study is not to assess the viability and efficiency of the Lebanese infrastructure. It is rather a logical suggestion of what can be done, with no delay, in some sectors that need immediate attention. Through the interviews we conducted, we could detect two fronts of action where big infrastructure projects are needed to increase the competitiveness edge of Lebanon and to maintain social wellbeing and welfare. The projects we decided to mention are not exclusive, and many others are to be considered in the same frame of mind.

1. Solid waste disposal and transformation factory.

   H.E. Mr. Yacoub Sarraf, minister of Environment[65], has currently presented to the council of ministers, in the general council of 15 June 2006 a project of law concerning a holistic management project for the disposal and transformation of the Lebanese solid waste. The project mentions that Lebanon produces 4,000 tons of solid waste daily, and the country has no infrastructure to transform and dispose of this waste production save by the rudimentary method of burying and filling-over. The achievement of this project

[65] Interview with H.E, Minister Sarraf on the 22-04-2006. Rf. Appendix C.

will benefit the society as a whole, and will relieve the municipalities of Lebanon from a burden of environmental proportions that they are unable and not prepared to deal with efficiently on an individual basis. The idea is to build various waste disposal and transformation factories in several parts of Lebanon.

2. Tripoli and Zahrani Oil Installations Refineries.

Lebanon has two crude oil refineries, the first one in the North of Lebanon, the Tripoli Oil Installations, and the second one in the South, the Zahrani Oil Refinery. Both are archaic and were partially destroyed by the war. When those refineries were operating, Lebanon used to import crude oil, through pipelines from Iraq and KSA, and refine it to petroleum derivatives supplying approximately 70-80% of the need of the country for energy combustible. Both refineries have become now huge tank farms to store refined petroleum derivatives that the country imports, mainly by sea transport. It is imperative to rebuild both installations, reducing the overall cost of combustible to the Lebanese industry and maintain a constant stream of fuel for the Electric generation plants. The interrupted supply of the fuel is the major cause of electric power interruption and rationing in Lebanon. These projects are vital and strategic for the improvement of the competitiveness of the Lebanese industry and the welfare of the Lebanese poeple. The lower cost of refining crude oil compared to the cost of importing already refined petroleum derivatives will reflect on the GDP of the country and on the public budget and expenditure.

4.5.1 Conventional infrastructure financing modes: BTO and BOT[66].

Public expenditures, divided into current and development expenditures, rely on different strategies and sources of finance to bridge the gap between of funds availability. In particular, for the development of infrastructure and projects expenditures, some important instruments have

[66] BTO : Build, Operate and Transfer- BOT: Build, Operate and Transfer.

emerged in the past few decades[67] (Iqbal, et al. 2004). In Lebanon, the high budget deficit would curtail the execution of some eminent infrastructure projects mentioned above.

The private sector has developed a significant public infrastructure programs in several countries in the world, like in Pakistan, HUBCO Hub Power Co, in 1999, under a BOO (Build Own and Operate) facility for US$1.5Bn, and in Malaysia, the Kuala Lumpur International Airport Sepang under a BOT arrangement[68].

The cost of such projects is passed to users and consumers in the form of competitive prices and better services. The financial accruals go to the private sponsors but public authorities also share in these accruals through fees and tax collections. The financial viability of such projects depends entirely on their cash flow generation, and the nature of their assets and liabilities. Hence, these projects must "stand-alone" as economic independent entities. In general the cash flow from the assets of the projects and the sovereign guarantees protect the interests of equity and debt providers. Governments also play a critical role as facilitators. (Iqbal et al. 2004)[69].

4.5.1.1 Structure of contracts and project management: Conventional approach.

Private infrastructure projects can take various forms of ownership, management, operational and maintenance structure. Some of these structures are summarized in Appendix H. The following table is the BOT, BTO, ROO and ROT (Rehabilitate, Operate and Own/Transfer) structures:

Structure	Description

[67] Iqbal, Munawar and Khan, Tariqullah (2004), "Financial Public Expenditure: an Islamic Perspective", Islamic development Bank Group, Islamic Research & Training Institute Jeddah-Saudi Arabia, p.75

[68] For more information on this project, please see www.jaring.my/airport/klia2/klia-details.html

[69] Idem 67.

Build Operate and Transfer (BOT)	It is a concession agreement, between an entity representing the public authority and a private party whereby the private party constructs and operates an infrastructure facility for a fixed time period and after that time period the ownership of minimal financial obligations. The project specifications are made by the public authorities and the project development and operation is carried out by the private party with full capital cost and expected earnings from the project revenues during the period of the concession. The purchase of project output is guaranteed by the government at a specified fixed price. The public authorities provide limited or no financial accommodation but substantial market and over risk coverage and guaranties. The whole process involves several contracts for sharing the risks, liabilities, responsibilities and returns. The arrangement enables the governments to facilitate the development of infrastructure projects without recourse to the government budget.
Build transfer and operate (BTO)	BTO is a short term BOT with a long term franchise for operation by the same private party. Hence the private party will design, finance, and develop the project on orders from public authorities and transfer the ownership of completed project to the public authorities on turnkey basis. Operation of the project will however, remain with the private party for a specified period for feels revenues sharing etc. during the post transfer operational phase; the financial obligations of public authority will be limited.
Rehabilitate, Own and Operate (ROO)	Under an ROO an existing public project is given over to a private firm for rehabilitation according to specifications. The private firm will own the project until it meets the initial conditions.
Rehabilitate, Operate and Transfer (ROT)	ROT is a fixed term concession like the BOT but the object is an existing public sector project and the objective is its rehabilitation and enhancement. Other than that, all conditions of the BOT may apply.

Table 4-14 BOT-BTO-ROO and ROT structures for infrastructure project-Private sector. Source : Iqbal et al. (2004) pp 77- . Ref. Appendix H for a comprehensive list of the same.

The above listed schemes are widely used by many governments to improve or build the infrastructure of their countries. The cost of the building and premises is amortized by the contract of operation, usually medium to long tenor, which allows the concessionary building company to operate and usufruct the products and services of the project until its NPV (net present value) becomes satisfactorily positive.

4.5.2 Islamic infrastructure financing mode: an Islamic BOT

Clearly the Istisna instrument, will allow the building of the project and its financing, being primarily a sale contract, with the Islamic bank as the "middleman" in the structure. Yet, an additional instrument ought to be introduced to finance the value of the project post-termination. Hence the government can enter in an Istisna mode of finance with a builder, and the payment of the Istisna will be agreed to be the right of the builder to operate and usufruct the project for a certain period of time. At the end of this period, the builder will return the premises to the government, the initial Istisna purchaser. The post Istisna phase looks like an Ijara contract. Similarly, if post-building the project, both the Government and the builder enter in a Diminishing Musharaka for a certain period of time, the builder will have the usufruct, the management and operation of the premises, until the cash flows generated cover the target NPV of his investment. At this moment of time, the Government acquires back the complete ownership of the assets.
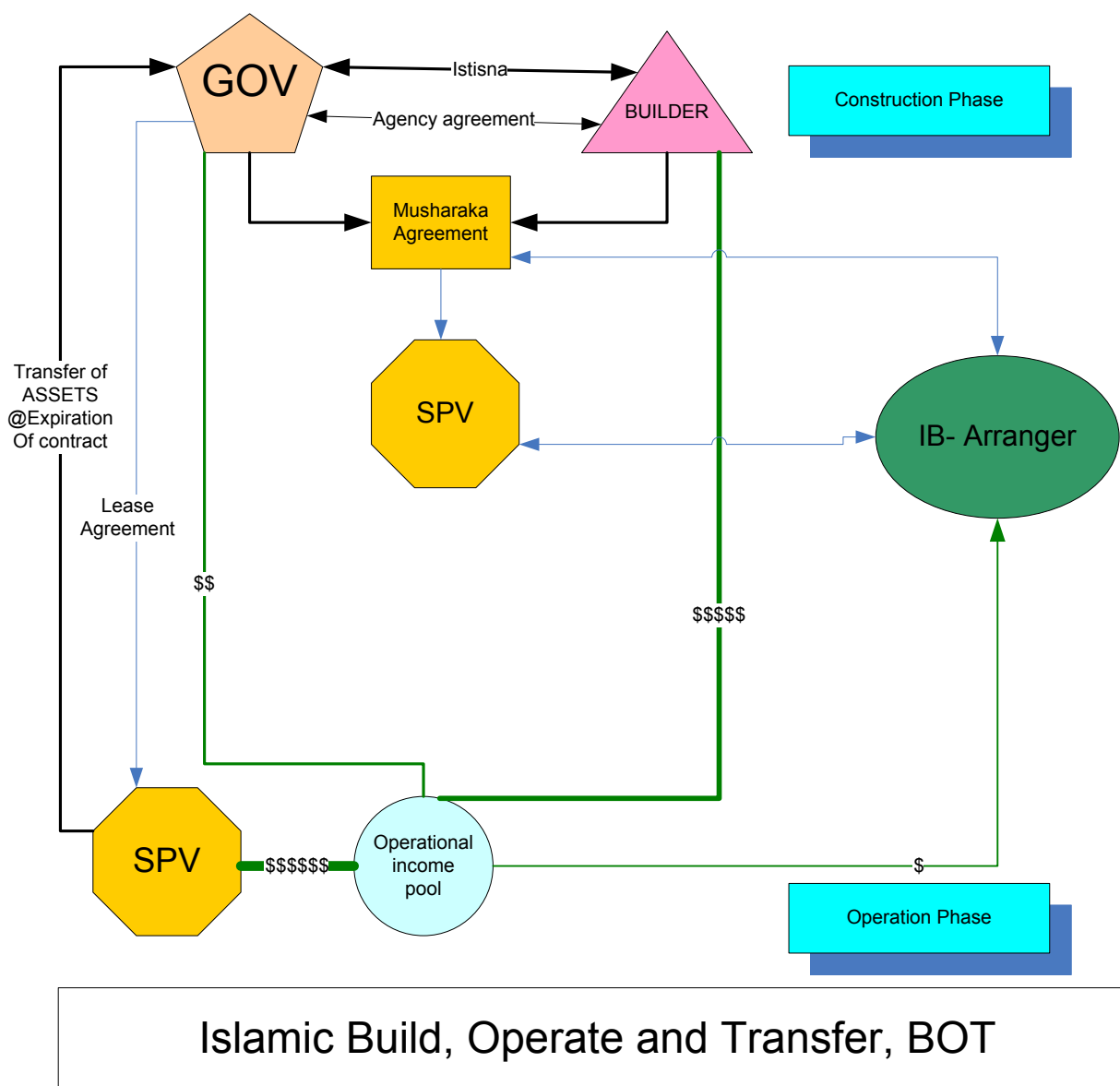
Figure 4-9 Islamic Build, Operate and Transfer, BOT for public infrastructure projects.

In the case of applying this structure to the rebuilding of the refineries, we envisage the issuance of Sukuk al Musharaka, as an alternative to long term financing, after the completion of the civil and mechanical construction work. We believe that considering the refineries as possible candidates for an Islamic BOT will attract GCC investors for the double benefit of being a Sharia complaint diversified investment in their portfolio and for its connection with the Petroleum,

being a prime material produced in the GCC and MENA. We foresee the possibility of some sovereign investors, interchanging crude oil against Sukuk al Musharaka, since barter is allowed by Sharia, being one of oldest modes of trade in the early days of Islam.

4.6 SME[70] and agricultural support: Musharaka, Mudaraba and Salam.

Most Lebanese SMEs , Small and Medium sized Enterprises, suffer from undercapitalization. Access to commercial credit, if available at all, is at a high interest rate and with a 2:1 collaterals ratio. More then 80% of companies in Lebanon employ less then 10 workers, constituting only 25% of the workforce, while 95% of companies employ up to 25 workers, constituting 65% of the Lebanese workforce. (Halawi, 1998).

The bulk of credits extended to SMEs are channeled to trade and services, constituting 68% in 2004 of the total credit extended by banks to private companies. The major cause of this singling out effect is that services and trade companies have the ability to generate profit and cash flows to service the debt in a short term. Lebanon does not have credit facilities for medium and long term projects, save for housing, and the longest tenor available in the Lebanese market, as of the date of this paper, is a Kafalat[71] government backed line of credit, for a maximum of US$200,000 for 5 years at subsidized interest rate as low as 2% per annum. These credits are limited to agricultural, industrial and touristic projects and start-ups.

The industrial sector, however, requires larger investment and working capital, with a longer tenor[72].

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[70] Many quantitative and qualitative criteria are used in Lebanon to define SME's , Small and Medium Enterprises. The most important quantitative factors are capital and the number of employees. The qualitative ones are type of ownership, management and technology employed. (Halawi, 1998)

[71] Kafalat guarantees 75% of the loan granted by the bank and charges 2.5% commission of the value guaranteed. For loans in Lebanese Lira, the bank charges the borrower 40% of the interest on Lebanese treasury bills of one year and the Central Bank subsidizes a maximum of 7%, or the interest charged, whatever is lower. For loans in US Dollars, the bank charges 1 Year Libor + 5.5% and the Central Bank subsidizes a maximum of 7% of the interest rate.

[72] Interview with Dr Fadi Gemayel, economic consultant to the Minister of Industry. Ref: Appendix C.

The industrial sector of Lebanon, suffers mainly from the lack or limited of long term financing opportunities, outdated technologies due mainly to the lack of capital expenditures and the traditional family owned business structure , hindering the exposure to modern management and technical expertise. Yet, Dr Fadi Gemayel, consultant to the minister of Industry, stated clearly that the Lebanese SMEs are accepting the idea to undergo into equity partnerships to compensate the lack of governmental support and difficulty of credit lines to finance their working capital and their capital expenditures in technology. We see here a great opportunity for Islamic Banks to tap this opening in a closed and cluster-like type of Lebanese commercial *modus operandi*.
In fact, Arab Finance House, is undergoing negotiations, at the date of this paper, with Rizk Hospital , Beirut, for an equity Musharaka agreement of about US$30Mn, to restructure the liability/ assets mismatch of the Hospital. No official communiqué has yet been issued, and the parties involved are not communicative about the deal. Yet, from the rumors in the sector, we could detect that the deal is about to be signed and it seems that the point of discussion is hinging around the management issues and governance of the hospital during the life time of the agreement. The exit strategy for AFH, will be a buy back option of the equity shares by Hospital Rizk at maturity. Hospital Rizk is not a listed company in the BSE (Beirut Stock Exchange).

4.6.1 Mudaraba Industrial Fund: an SME supportive investment line

By definition and nature, Mudaraba deposits, Restricted or Unrestricted, are investors' deposits in Islamic banks dedicated to produce revenues through a Profit and Loss sharing scheme through investments that the IB undertakes in several sectors of the economy.

When Restricted, the IB has the obligation to invest these deposits in a specified economic activity that the depositor chooses, when Unrestricted, the IB invests the deposits in economic endeavors and will disclose the revenues to the depositors to support the PLS sharing ratios. Lebanon has both Restricted and Unrestricted Mudaraba deposits. Table 2-4, Page 17, shows that the Mudaraba deposits represent 1% of the Lebanese Islamic modes of finance. This being overtaken by far by Murabaha, which remains the fastest and easiest Mode of Finance in the country.

We believe that much could be done on this front, and the market drivers are clearly prominent in the sense that SME do not really have alternative sources of finance. There is a market demand for ANY type of structured financing for SMEs and the Islamic Banks are invited to consider this as a viable value driver for establishing a complete market study to assess and quantify the market volume from one side, and the preferences of the Mudaraba depositors from the other.

4.6.1.1 Mudaraba[73], an Islamic mode of Equity finance: technical insight.

Mudaraba is based on the concurrence of capital owners, Rub el mal, and expertise. The Rub al Mal provides the capital and the other party provides the expertise and the know-how with the purpose of earning Halal profit through a Halal activity. The profit will be divided between both parties in an agreed upon ratio.

The Mudarib, being the working agent and the expertise holder, manages the capital of the Rub al Mal to the best of his efforts to create value and profit. Investors deposit their capital with the Islamic banks in Mudaraba accounts, allowing the IB to advance these funds to any economic activity (Unrestricted Mudaraba Accounts) or to a specified economic activity (Restricted Mudaraba Accounts).

Actors and rules of a Mudaraba investment:

1. The investors: Rub al Mal, deposit their capital in Restricted or Unrestricted Mudaraba accounts with the Islamic bank.
2. The Islamic bank: provides the capital as a capital owner, on behalf of the depositors/investors.

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[73] Contents and concepts of this section are extracted and adapted from Khoja, Ezzeddine Mohd and Abu Ghudda, Abdul Sattar (2002), *Instruments of Islamic Finance*. Research and development Dept. Al Baraka Islamic Bank. Ch.IV, PP110-

3. The Mudarib: provides the effort and the expertise for investing the capital received from the IB, as a Mudaraba equity finance mode, in exchange of a share of his profits.
4. PLS , Profit and Loss Sharing: at the end of ach period, the two parties, IB and Mudarib, calculate the profits and divide them according to the agreed upon ratio. In case of Loss, the capital owner (the bank and hence the depositors) bears the loss.
5. Mudaraba Capital recovery, two alternatives
    a. The Bank recovers its capital before dividing the profit, since profit is considered to be a protection to the capital. Hence the Mudarib is not allowed to collect his share of the profit until he returns the capital. If a loss occurs in a subsequent period, it should be offset by the previous profit produced.
    b. If agreed upon, a periodical distribution of profit is done before the final settlement of the Mudaraba capital. The profit distributed will remain on account until the security of the capital recovery is assured.
6. The Mudaraba capital advanced must be known and quantified in advance. It should be stated in the contract or else an uncertainty will occur. It cannot be stated, for example: "the IB will advance capital to finance the operations of company X". This is considered a Gharar. It should state clearly : The IB will advance the amount of US$Y to finance the operation of company X". The capital can be in species provided it is evaluated in the contract and this evaluation will become the Capital of Mudaraba.
7. The capital advanced in a Mudaraba is not a debt or liability on the Mudarib. The Mudarib is a trustee of the funds advanced.
8. The capital of the Mudaraba can be released gradually. Some scholars disagree on this issue and rule that the Mudaraba capital is to be advanced in its totality at the signature of the contract.
9. It is permissible by the Bank to impose certain restrictions on the Mudarib, provided these restrictions do not interfere or restrain the Mudarib from producing the profit

required and is not counterproductive. Restrictions and requirements for proper accounting practices, reporting, auditing and sound governance will be an assurance to the Bank that the Mudarib is managing the activity transparently and legally.

10. No security on the Mudarib shall be stated in the Mudaraba contract except in case of negligence or violation of the restrictions stated above. In this sense, Capital is considered deposited in a Trust agreement and not as a debt.
11. It is permitted for the Bank to take a mortgage from the Mudarib to cover the payment in case of negligence or violation of restrictions. **The mortgage is NOT a security or a guarantee to the capital or the profit. Sharia forbids clearly guaranteeing profit or capital.**
12. The Mudaraba is terminated if one of the two parties rescinds it, because the Mudaraba contract is optional and not a binding one.

4.6.1.2 SMEs in Lebanon and Mudaraba Fund mode of finance.

The profile of this mode of finance presents a higher risk for the IB, as a Mudarib vis-à-vis the depositors. In Lebanon, the need to establish this “line of equity financing and profit/loss sharing” being expressed, the IB should make sure at least three conditions are met before it undertakes such a project:

a. A proper feasibility study of each Mudaraba contract. High risk will be translated into high return. The benchmark to such a high risk should be at least equal to a consumption loan, being around 11-12.5 % per-annum. Hence the need of a centralized economic and marketing research department in the Bank, and this would be an independent business unit, charging the Mudarib a fee for its initial study.
b. A proper fiscal and accounting standards control. Profit sharing will rely on accounting reports. The Mudarib could not be left to his accounting standards and habits, and a proper and standardized accounting standards should be imposed on

the Mudarib, in the form of tacit clauses of restrictions in the Mudaraba contract. We suggest the establishment of an accounting consultancy department in the IB, which will control and audit periodically all Mudaraba projects. The infringement of this restriction will incur the Mudarib in a breach of contract and the guarantee he advanced will come into effect to reimburse the capital. We believe that this rule should be very stringently applied. The Mudarib will pay a fee for the services of this department.

c. Far from interfering in the day-to-day business of the Mudarib, the IB should have a proactive interference with the management skills and standards of the Mudarib. Most SMEs in Lebanon are family owned business, lacking modern and scientific expertise in global management and commercialization. Cost control is crucial to achieve a higher rate of profit. Additionally, scrutiny should be exerted on the payroll of the Mudarib. Many a company employs members of the family and close relatives, and a benchmark to the market wages should be conducted to rate the employment level, salary scales and quality of the Mudarib company. This could be achieved by establishing a management consultancy firm that provides training, management skills advisory and human resources screening and benchmark to the Mudarib. This department will host also the technical team, specialized in each and every activity that the IB wished to establish a Mudaraba contract with. This department will invoice its fees to the Mudarib.

On the surface, the above recommendations seem to burden the profit rate of the Mudarib, since each clause represents an additional fee and cost that the Mudarib is required to assume in order for the IB to consider entering in a Mudaraba contract with him. Yet, from a commercial perspective, the Mudarib knows that he will benefit from this consultancy, from one side, and knows that, since he shares the profit but not the loss, the IB has to protect its interests and those of its depositors. The Mudarib will understand that the “benefit” and Sharia mandate of not being responsible for an eventual loss, unless due to his negligence or infringement of the restrictions, has to be reciprocated with a proper and orthodox governance, accounting standards and pristine

management attitude. We believe that this issue is a *UNIQUE SELLING PROPOSITION* of a product to be launched in the Lebanese financial market. Again, this mode of finance, designed to fulfill the Sharia mandate of profit sharing and loss bearing, along with the above mentioned restrictions to be imposed on the Mudarib, is a point of tangency between Islamic Finance and the Lebanese law of Contracts and obligations. The unaware minds are invited to understand that Islamic finance is not about charity only. Islamic finance is about making profit, benefiting the society and complying with the Sharia mandate. It is indeed an alternative and profitable way of doing business.

We propose the following scheme to illustrate our point of view:

MUDARABA FOR LEBANESE SMEs SCHEME.
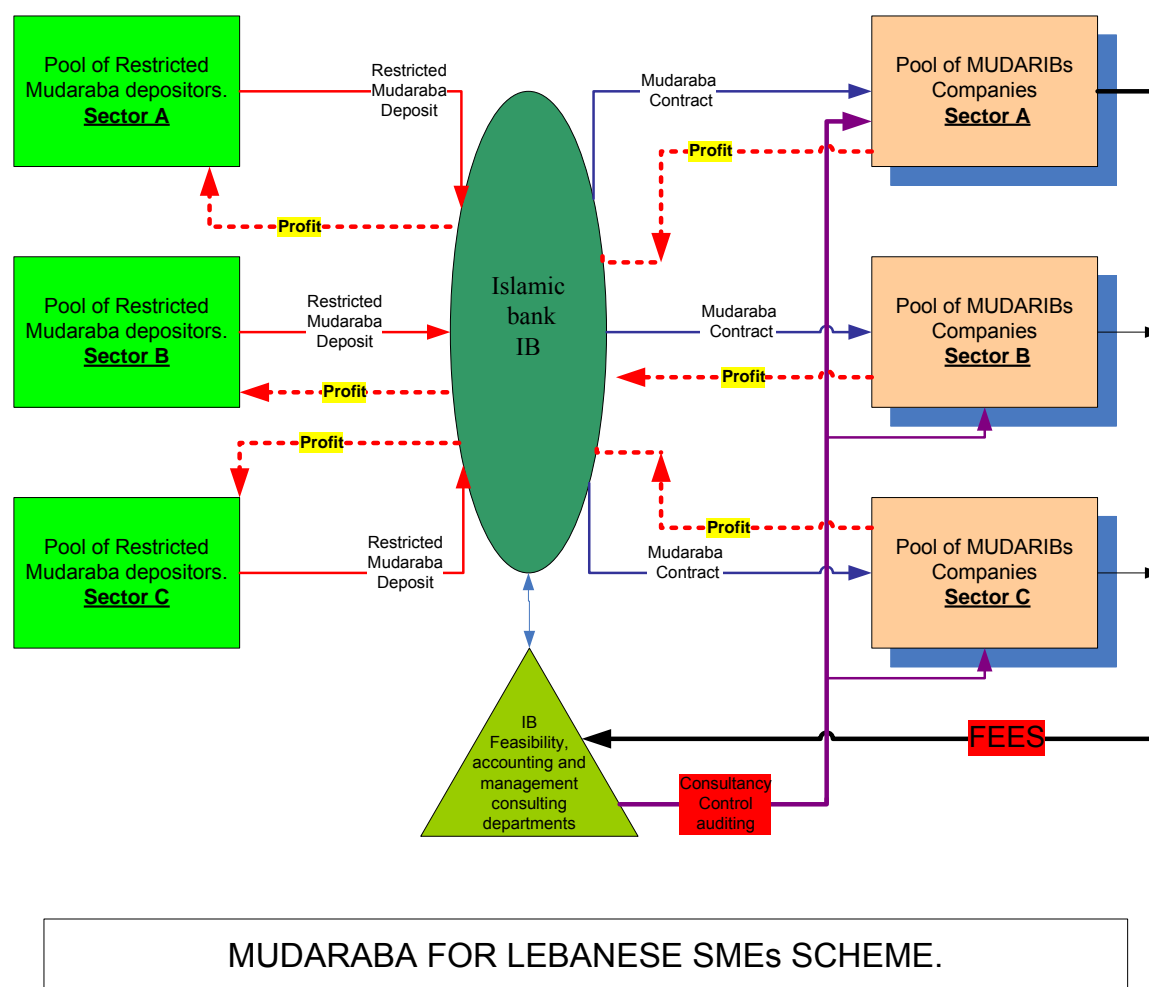
Figure 4-10 Mudaraba deposits and contracts for the Lebanese SMEs.

As mentioned earlier in this sub-section, this is a risky investment, and the return on profit should be high in order to remunerate the risk involved. At the same time, if the IB is capable of maintaining a close control and involvement with the Mudarib, foreign investors and local depositors alike would be attracted with the higher rate of return produced and will be willing to participate in the scheme, depositing their funds in Restricted Mudaraba deposits with the IB. The IB has the double task to create a systematic control and evaluation approach vis-à-vis the Mudarib, and to design a clear and comprehensive communication campaign to present the benefits of such an investment mode for the depositors.

4.6.2 Salam and Parallel Salam: Lebanese agricultural products

The Lebanese rural areas are mainly agricultural societies organized around the products cultivated in their region. The South is mainly tobacco planting oriented, while the North and the Chouf rely mostly upon olives and olive oil and fruits like citric and apples. The Bekaa valley is oriented primarily to beetroots and wheat. Part of this agricultural production is consumed internally, in the Lebanese market, and the remaining part is exported to neighboring countries. The agricultural commercial activities are not very much organized. It relies on individual efforts. One of the products that have found many channels of distribution abroad is OLIVE OIL.

In Lebanon, no evidence of an OLIVE OIL or OLIVE cultivators cooperatives has been noticed. Some families export their high quality virgin olive oil through intermediaries or through direct contacts.

Lebanon exports 500tons of olive oil per year[74]. The USA is the major world olive oil importer, accounting for 35% of the world olive oil exports. The top world olive oil producers, Italy, Spain and Greece, are increasing production and cultivation acreage, and the EU producers are forming alliances with non-EU producers to cater for the increasing demand.

The Lebanese olive oil is well accepted and valued in foreign markets. Lebanon mainly sells olive oil, bottled and labeled as “High quality” or “specialty” olive oil. It is also marketed as

[74] International Olive Oil Council (IOOC) Dec 2003 data.

organic olive oil, and it is considered to be in the category of “virgin” or “extra virgin” olive oil. Exports from olive oil in Lebanon are estimated to be around US$500Mn per year.

The olive oil producers are mini agricultural rural families relying upon their yearly crop to subside. They have meager to inexistent access to financial products, credits or support. The basic loan providers are the black market money lenders and the interest rate they charge is very high and surpassing usury levels.

The international Olive Oil Council, IOOC ranks Saudi Arabia as the major GCC-MENA region olive oil importer, at a level 5,500 tons per year.

We propose an Islamic Financial structure of Salam and parallel Salam, to buy the olive oil produced by the Lebanese farmers and sell it to an importing country, in this case KSA.

What applies to Olive oil, is also valid for citric products, fruits, tobacco and honey.

4.6.2.1 The Salam Instrument.

Al Salam is a transaction where two parties agree to carry out the sale (the farmer) and the purchase (the Islamic bank) of an underlying Asset (olive oil, in this case) to be delivered at a future date but at a price determined and fully paid on the day the contract is entered into. This is in some way similar to a conventional forward contract the difference being that the buyer pays the entire amount in full and in cash at the time the contract is initiated.

The Salam contract features are:

1. The seller being the farmer gets in advance the money he needs in exchange of his obligation to deliver the commodity (olive oil) later. He benefits from this advance payment to cover his financial needs, whether personal or productive.
2. The purchaser, the IB in this case, gets the commodity it is planning to trade in the time agreed upon. The commodity becomes the liability of the seller. The IB will also benefit from getting the commodity at a cheaper price to remunerate his advance payment. This in turn will cover the IB from the price fluctuation or volatility.

3. The IB receives the commodity and is free to trade it on cash or on credit. It can also enter on a parallel Salam, i.e. a Salam with a third party, where the IB is then the seller and the final customer is the purchaser. One condition should be met: the IB cannot condition the second parallel Salam contract to the existence or the completion of the first. Both agreements should be independent and stand-alone. **It is to be noted that the IB cannot sell the commodity prior to receiving it. He can only do a parallel Salam, or else it will be selling a debt liability, the commodity, which is not Sharia compliant.**
4. The IB can authorize the seller, the farmer in our case, to sell the commodity on its behalf against a management fee or without it.
5. The IB can direct the seller to deliver the commodity to a third party (the final buyer) according to a previous promise of purchase, being an emphatic demand of purchase. The final sale price is at a higher price then the purchase price, and it can be in cash or deferred payment.
6. The IB can monitor the quality and specifications of the commodity he purchased by Salam. If the commodity cannot be monitored by specifications, Salam is not possible, because there is an ignorance factor, Jahala, which can lead to disputes.
7. Salam is impermissible if the probability of existence of the commodity on its due date is low. Save “force majeure”, the commodity should have a high probability of delivery on the date agreed upon.
8. Salam contract allows partial deliveries, on dates agreed upon.
9. Salam is not permitted on existing commodities at the time of the contract.
10. It is permitted to take a mortgage or a guarantor for a Salam debt to guarantee that the seller satisfies his obligation by delivering the commodity sold.

The Salam instrument can be used by IB in Lebanon to purchase, with a future delivery, the olive oil from farmers, according to the specifications required by the international clients. It

will also do a parallel Salam with a KSA purchaser or purchasers, to deliver the goods according to a time table and product specifications. This double operation will improve he quality of life and welfare of the farmer, having the benefits of selling their product in advance and cashing an amount of money not eroding with the black market high interest rates of the money lenders.

Additionally, the IB can sign a parallel Salam with the end purchaser, guaranteeing hence the final sale of the commodity to be received. If Sukuk structure is authorized in Lebanon, the IB can issue Sukuk al Salam, with the underlying commodity being olive oil. The IB will designate an off-taker, related to the bank, which will sign an agreement to purchase the commodity at a fixed price, ensuring no price fluctuation for the Sukuk holders on the underlying asset. We propose the following schemes for the Olive Oil Salam, parallel Salam, and Sukuk al Salam which can be extended to many other agricultural commodities produced in Lebanon. The structure is depicted in Figure 4-11 below.
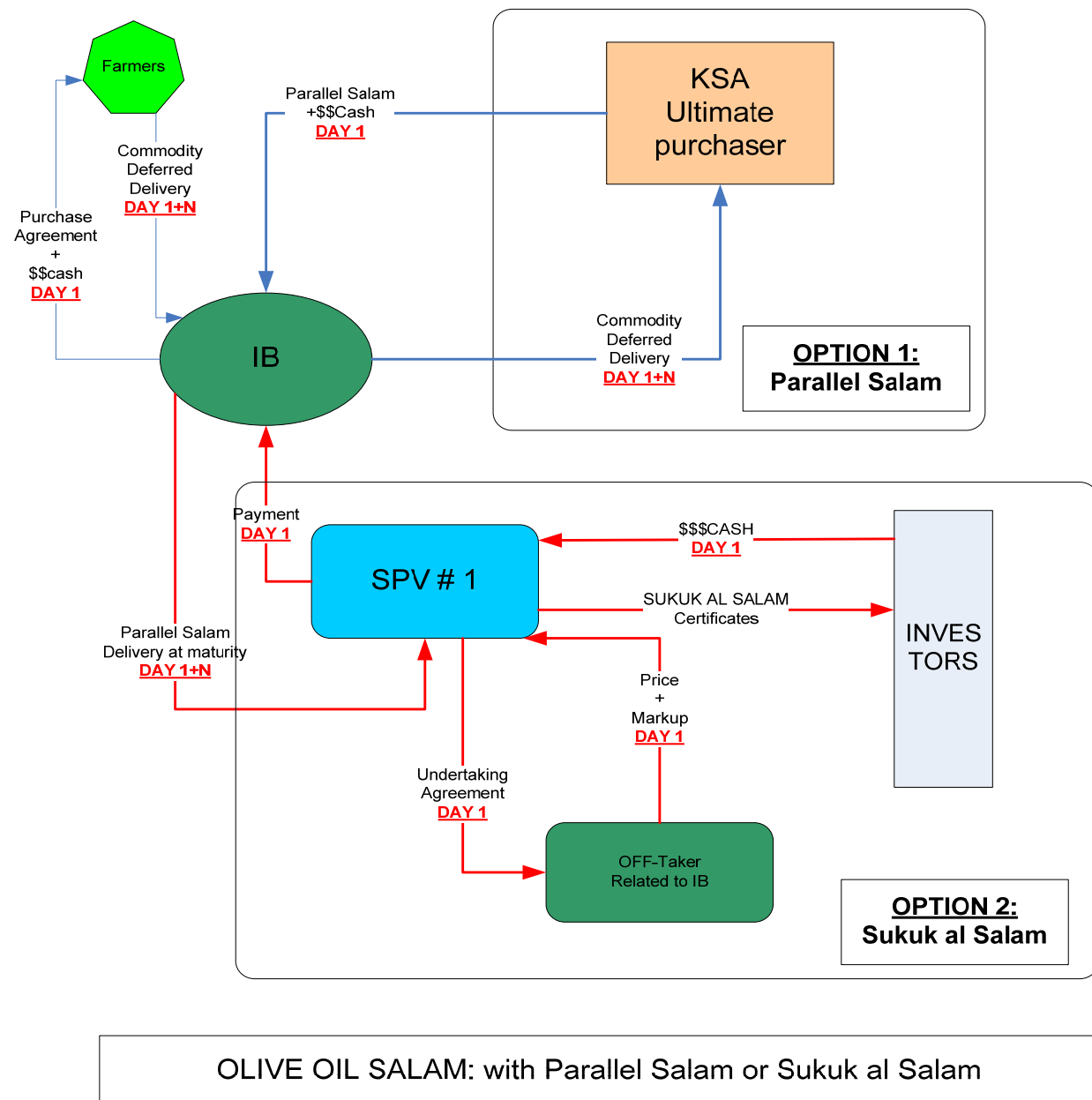
Figure 4-11 Lebanese agricultural support: Salam, parallel Salam and Sukuk al Salam scheme

4.7 Islamic Microfinance.

"Microfinance is the provision of a broad range of financial services such as deposits, loans, payments services, money transfers, and insurance to poor and low income households and their micro-enterprises[75]."

The banking system in Lebanon in particular, is very cautious extending credits to poor people. The credit analysis departments of several Lebanese banks rely on many indicators that the micro-companies do not possess:

Character: means how a person handled past debt obligations: From credit history and personal background, honesty and reliability of the borrower to payment of credit debts. All credit applications are submitted to a database credit history analysis.

Capacity: means how much debt a borrower can comfortably handle. Income streams are analyzed and any legal obligations looked into, which could interfere in repayment.

Capital: means current available Assets of the borrower, such as real estate, savings or investment that could be used to repay debt if income should be unavailable

These three **"C's"** of credit analysis and application process are a true handicap for a small family business looking for financial credit. Usually, these small micro-projects, being banned *ad natura* from banking facilities as a whole, will look at the black market of debts and loan sharks[76] to finance their small micro-projects. The outcome is typical: the family works to pay the interest of the money lenders, let alone the principal, and the total result is underdevelopment and misery.

Commercial banks in Lebanon are reluctant to lend to the poor largely because of lack of collaterals and high transactions cost. The amounts of the credit are usually small, ranging from

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[75] Asian Development Bank (2000), "Microfinance Development Strategy for Asia-pacific region", ADB publications, p.1

[76] Money Lenders who charge a daily interest rate of around 1%. They tend to leand money for several days, and the payements are collected by their agent. They lend on a case top case basis, usually to merchants and households they know.

US$500 to a maximum of US$5,000, and the administrative cost of handling and processing for the bank per credit becomes high, eroding out the margin of profit given through the placement-credit spread. The concentration of micro-companies in rural areas and suburbs of the Lebanese major cities complicate further the situation: banks prefer to deal with large-scale farmers and entrepreneurs because the branches administrative and control functions are limited and not prepared to deal with a medium volume of operations.

A recent study in Malaysia by the ADB (Asian development Bank) stated that microfinance in the Asia pacific region is a major factor for development and welfare to the poor and less privileged.

In brief, microfinance is an unexplored niche of business by the banking sector in Lebanon and the area, and many research papers have stated its feasibility:

1. Good return on equity-average: Microfinance ROE was 11.1% in 2001. (Source: Stauffenberg, Microbanking Bulletin Nov 2002)
2. Medium risk: 50% of banks making micro enterprise loans, have less than 50% of their micro loans in arrears. (Source: Jenkins, Harvard Institute for International Development)
3. Huge demand: over 900 million people in about 180 million households in Asian and Pacific region live in poverty. (Source: Asian Development Bank).

4.7.1 Microfinance in Lebanon. Present situation

The demand in Lebanon for microfinance services is not quantified. A survey and a market study should be conducted to assess the market volume and the economic activities in need of such a product. The UNDP[77] reports the following:

"Poverty in Lebanon is mainly a function of geographical and socio-economic disparities, Initial attempts to measure post-war poverty in Lebanon began mainly in preparation for the Social Summit for Social Development (1994, Copenhagen), and suggested that the poorer categories of the Lebanese population are civil servants and farmers; and that rural poverty is a considerable especially in remote areas of the Baalbeck-Hermel and Akkar in Northern Lebanon

[77] Source: http://www.undp.org.lb/programme/pro-poor/poverty/povertyinlebanon/index.html

and the recently liberated region of Southern Lebanon. According to the Living Conditions Index, 32.1 percent of households or 35.2 percent of the Population live below the satisfaction threshold. These are divided between households having a very low degree of satisfaction, including 7.1 percent of households (6.8 percent of individuals), and those having a low degree of satisfaction, including 25 percent of households (28.4 percent of individuals). Households having intermediate satisfaction represent the largest component, with 41.6 percent of households (42.2 percent of individuals), while households having a high degree of satisfaction account for 26.4 percent of the total (22.3 percent of individuals)."

The report concluded with recommendations ranging from social, educational health care, housing and income related issues. The UNDP recommends on "improving the income of the poor in Lebanon[78]" the following:

"Income-related indicators

Improvements in income indicators depend primarily on macro-economic and wage policies. This, however, does not obviate the need for issue-specific interventions. ***Recommendations:***

- *Adoption of measures to create an environment conducive to the establishment and growth of small and medium enterprise (loans and banking facilities, discounts, legislative incentives,...).*
- *Modernization and expansion of the scope of vocational rehabilitation and training.*
- *Promotion of income-generating projects. "*

Source: UNDP-Lebanon

Additionally, relying on our interviews we can state the following premises concerning microfinance in Lebanon in general:

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[78] Source: http://www.undp.org.lb/programme/pro-poor/poverty/povertyinlebanon/molc/recommendation.htm

1. There is a proliferation of credit black market and informal microfinance by loan money lenders.
2. Many NGOs (Non Governmental Organizations) and religious associations are now assuming the role of micro financiers when possible and when their subsidized funds allow it.
3. One of our interviewees, who asked not to be quoted, admitted that the religious association to which he belongs has already advanced micro credits for the amount of US$10Mn in the past 2 years. They advance credits ranging from US$500 to US$5,000 without collaterals.
4. If microfinance is organized and institutionalized, we estimate the market volume to be around US$200Mn in the coming 5 years. This number is based on the previous point 3 and on the UNDP estimate of 35% of Lebanese individual living below the satisfaction conditions.
5. The government is not tapping the income tax and VAT generated by the the informal economy in Lebanon. Organizing microfinance would reframe the unofficial economies into small organized entities that will contribute to the fiscal income of Lebanon.
6. Organized microfinance will open the doors to all eligible micro enterprises to access financial services. Today, informal microfinance is only available to those who are aware of the existence of such product with some NGOs and private associations.
7. The close control and monitoring exerted by organized microfinance on the micro-companies would create a fertile and organized ground for those micro enterprises to grow and prosper.

Actually many microfinance companies offer the financial services to small family businesses and individuals. The most prominent companies are Al Majmoua and AMEEN[79]. Table 4-15 below summarizes the performances of these companies.

Microfinance in Lebanon: 2004 comparative data of the two market leader		
CHARACTERISTIC / DATA	**AMEEN**	**AL MAJMOUA**
Credit portfolio volume (thousands USD)	6,700	5,150
N° active clients	7,886	6,000
Percentage of male clients	79%	90%
Loan period , months	4 - 18	6 -12
Loan size in US$	300 - 5,000	500 - 5,000
Installment	monthly	monthly
Interest rate	22-28%	20%
Collateral	1 co-signer	1 co-signer or real guarantee
Repayment rate	100%	89%
Source: compiled by author		

Table 4-15 Comparative table of the two Lebanese leaders in microfinance.

AMEEN has been able to achieve a 114% operational self-sufficiency and 110% financial self-sufficiency. This positive performance can be explained by:

- Good Portfolio Quality: AMEEN has been very cautious in its client selection. Arrears rate is 0.63%; the portfolio at risk (PAR) is 0.53% over 30 days, with risk coverage of 2.8%. The loan loss rate was only 0.24% from October 2003 till September 2004. The commercial funding Liabilities ratio stood at 1.19% at the end of September 2004 and the internal source to loan ratio stood at 2.65% from October 2003 till September 2004.

[79] For more details on the operations of Al Majmoua, please see www.almajmoua.com , and for AMEEN (Access to Microfinance and Enhanced Enterprises Niches) please see www.ameenchf.org

• <u>High Portfolio Yield:</u> The real effective interest rate has been 33%. This high interest rate is expected for Microfinance institutions in order to achieve sustainability. Two main forces drive interest rates higher than commercial loans: The first one is the client credit worthiness and the second one is high administrative costs.

• <u>Operating expenses</u>: Ameen has been able to keep expenses at a relatively low level compared to other micro finance institutions in the region. The personnel expense ratio stands at 22% for the period extending from October 2003 till September 2004.

Al Majmoua, has shown a sustained growth and expansion over the past years since its inception in 1998, as shown in Table 4-16 below.

Microfinance: Al Majmoua, Lebanon			
INDICATORS	**2004**	**2001**	**1998**
OUTREACH			
N° active clients	6000	5800	3500
Credit portfolio (thousand USD)	5150	3020	840000
Average loan size (USD)	855	523	244
Loan ≤ 300 USD	8%	29%	47%
Clients under the poverty line	10%	11%	18%
Female clients	45%	61%	100%
FINANCIAL PERFORMANCES - SUSTAINABILITY			
Total active (thousand USD)	6930	5710	3440
Share capital (thousand USD)	6360	5220	3410
ROA (Return on assets)	5.77%	-1.33%	-
ROE (Return on equity)	6.08%	-1.43%	-
Operative sustainability	121%	81%	71%
Financial sustainability	119%	80%	54%
OPERATIVE EFFICIENCY			
Operative expenses/loan portfolio	27.60%	41.70%	53.40%
Cost per client (USD)	224	218	-
N° clients per credit officer	97	96	115
DELINQUENCY RISK			
PAR (portfolio at risk) › 30 days	2.29%	4.94%	0.29%
Written off credits	1.81%	2.02%	0.30%
Source: www.Almajmoua.com and www.mixmarket.com			

Table 4-16 Al Majmoua indicators and financial performance, 1998-2004

Both companies differ in their business model and *modus operandi*. Yet, this proves that the microfinance niche is still in its first steps and the potential of growth is considerable, knowing that in Lebanon, the UNDP estimates the number of people in need of such services is a round 45,000, assuming one loan per family. We believe that an Islamic Microfinance scheme could be explored as a differentiating property to penetrate this market segment in Lebanon.

4.7.2 Islamic Microfinance in Lebanon: A differentiating approach.

As seen above, the microfinance services offered are not Sharia complaint, at least on one count of interest based loans. Although the cost of operation and administrative overhead for a microfinance financial facility is high, we believe that the finality of microfinance is in concordance with the Islamic precept of mutual help and solidarity. Scholars affirm that the prohibition of Riba in itself is a social measure to protect the poor, giving him access to resources and sharing with him the risks involved. Philosophically and theologically, we believe that microfinance is the essence of the Islamic Sharia precept of Fiqh al Muamalat[80]. God gave man the richness of the Earth, to worship Him, prosper and share them with others. From this standpoint, Islamic microfinance is an act of worship and an ultimate abidance by the laws and Sharia of the All-Mighty: Those more privileged are to assist and help the less privileged.

Many Islamic Financial instruments are available for microfinance as well. Mudaraba, Murabaha and Salam are a way of providing capital to those in need of it, regardless of the amount of the same. Musharaka provides equity financing for starting up a new company no matter how small it is, and working capital needs while sharing profits and losses all the same. In that sense, Islamic instruments of financing, by their concept and scheme of operation, do not specify the amount or volume of the project or activity undertaken. This is in contrast with conventional modes of finance, where volume justifies and modulates the rate of return and the amount of risk: Islamic modes of finance share the risk and the revenues, conventional modes require a fixed return, the bigger the better to absorb the overhead costs.

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[80] Islamic commercial jurisprudence or the rules of transacting in a Sharia compliant manner.

The structure of Qard Hasan[81] reflects the social gradient of the Islamic financial structure, giving money to the needy with no return or promised revenue. We believe that the Lebanese Islamic banks, should consider the establishment of Microfinance units. This would enhance their visibility in the society and would attract a big number of clients, although the volume of transaction is small. It is our firm belief that this activity would help in the social effort to reduce any cultural shock or misconception, if at all existing. One more feature of the Islamic microfinance in Lebanon is that no banks are operating under this scheme of micro financing small projects, but only private corporations. These corporations are not allowed to capture the savings of the small borrowers because they do not have the proper license from the BDL. In contrast, Islamic banks can extend a microfinance line of credit to the small borrower, and at the same time extend to him the facilities of saving and depositing his funds with the bank. This would improve the collateral level of the same and would capture a bigger amount of market share, in the firm belief that extending microfinance credits to small borrower will help developing richness and economic growth. This is an integral financial effort, exerted by the Islamic financial institutions, both responding to a Sharia mandate, and to a national necessity much coveted and desired.

The broad spread created by the market interest rates for microfinance leaves an ample margin for maneuver and for establishing a solid infrastructure to manage atomized small credits spread geographically and across the economic sectors of activities.

From what proceeds we can draw the following conclusions vis-à-vis Islamic microfinance in Lebanon:

1. It is a growing market niche
2. No organized Islamic microfinance companies are yet established in Lebanon.
3. Islamic microfinance requires 5 C's:
    a. Constant control and close relationship with the client

[81] Benevolent loan with no revenue or profit margin. The borrower returns the exact amount of money he borrowed after a certain period of time.

b. Constant Collection of installments.

c. Community involvement. The group collaterals or the group recommendation is a must for the success of a microfinance project in Lebanon and elsewhere.

d. Constant visits to the client. It is through a direct assessment of the health and proper functioning of the micro project that the rate of repayment will increase. A rate of repayment of 98% has been achieved in Lebanon, mainly due to constant visits and direct involvement with the bank agent.

e. Consultancy and help. The steady and comprehensive consultancy needed does not require high grade business consultant. Yet, the absence of such guidance could drive the micro project to default and bankruptcy. It is through proper advice and help that those micro projects could evolve to become SMEs in a medium term. This should be the ultimate goal of the Islamic microfinance endeavor: to create future prospects for a SMEs in Lebanon.

4.8 Islamic Funds: Lebanon as a investment platform

Investment funds are, by definition, a pool of funds invested in Sharia compliant companies, in form of equity stocks, and receiving Sharia compliant revenues. The subscribers of the Fund may receive a document certifying their subscription and entitling them to the pro-rata profits actually earned by the Fund. These documents may be called 'certificates', 'units', 'shares' or may be given any other name, but their validity in terms of Sharia, will always be subject to two basic conditions:

Firstly, instead of a fixed return tied up with their face value, they must carry a pro-rata profit actually earned by the Fund. Therefore, neither the principle nor a rate of profit (tied up with the principle) can be guaranteed. The subscribers must enter into the fund with a clear understanding that the return on their subscription is tied up with the actual profit earned or loss suffered by the Fund. If the Fund earns huge profits, the return on their subscription will

increase to that proportion. However, in case the Fund suffers loss, they will have to share it also, unless the loss is caused by the negligence or mismanagement, in which case the managing bank, and not the Fund, will be liable to compensate.

Secondly, the amounts so pooled together must be invested in a business acceptable to Sharia. It means that not only the channels of investment, but also the terms agreed with them must conform to the Islamic principles.

In conformity with these conditions, Lebanese Islamic banks and financial institutions could pool up funds from investors to place them in Islamic funds they manage. The transit of funds through Lebanon in both directions, i.e. from investors to the companies, and from companies to investors, will generate a substantial commission and transaction fees that will enhance the performance of these entities and create wealth, employment and visibility. Yet again, GCC investors have access to Islamic funds, diversified portfolios and online trade. The list in Appendix G bears witness to the proliferation of Islamic funds and to the substantial amount of money involved.

What will be the differentiating advantage of the Lebanese managed funds over its competitors, to attract investors to channel their investments through Lebanon and not through another country?

4.8.1 The Lebanese Fiduciary law: a launching pad to Islamic Fund management.

As discussed in section 2.1.1.3 page 14 above, the Lebanese Fiduciary law is covered by the Lebanese banking secrecy law. Its flexible regulations allow Islamic banks in Lebanon to rely upon it as a launching pad for structuring Islamic funds. We see this as a differentiating property of the Lebanese Islamic market place over many of its neighboring countries for the following reasons:

1. Funds entrusted in a fiduciary contract are not consolidated with the capital assets of the client or "constituent" party. Hence they do not constitute a liability back-up when the client defaults or is declared bankrupt. Depositing his funds in a fiduciary contract

in Lebanon, the client is sure that his principal and revenues are protected against any legal action against him[82], and are covered by the Lebanese banking secrecy law. We believe this could be a Unique Selling Proposition on its own.

2. Funds entrusted in a fiduciary contract are not subject to inheritance laws and regulations since they are not declared in the patrimony of the client when deceased. Hence the client can appoint any person or third party, physical or corporate, to inherit the capital and revenues of his trusted funds. This feature is very important when family conflicts or complications are present, and it can be presented as a solution to distribute the inheritance to some members of the family or close relatives not contemplated by the "law of the land" inheritance laws of the client.
3. The law permits the client or constituent to appoint any third party for the usufruct of his assets deposited in a fiduciary contract. Clearly this feature of wealth management is unique in the sense that a fiduciary contract can be used to allocate a steady stream of income to any third party appointed by the constituent, and this operation is covered by the Lebanese banking secrecy law. We see this feature as a second Unique Selling Proposition and should be considered as a marketing tool for the sales team involved in selling the product to the investors community.
4. If the constituent is non-resident and non-Lebanese, the revenues generated from the fiduciary contract are not subject to income tax.

From the above points of differentiation, we believe that the Lebanese Islamic Financial institutions can constitute an Islamic fund, screened to comply with Sharia mandates, the IB being the Manager. In parallel, the IB entrusts the investors' capital to a fiduciary contract that invests its pool of cash in an Islamic Fund that the IB constitutes and manages. This double action of Fiduciary-Islamic Fund is a differentiating feature of the Lebanese market place and

[82] Money laundering investigation being recently excluded from the banking secrecy protection.

constitutes a Selling Proposition to attract funds from the GCC and MENA region to be entrusted and managed from Lebanon by Lebanese IB.

Lebanon could become a wealth management hub attracting potential GCC investors to consider investing in Islamic Funds through a fiduciary contract.

A complete set of documentation and marketing tools are required to assist the sales force in creating awareness within the investors community concerning this product, and we envisage appointing an agent IB in each country targeted to present this investment tool as an alternative to his clients for a commission or profit sharing scheme with the Lebanese originating IB.

Moreover, Lebanese IB could rely on the Islamic funds created and managed by the GCC IB to include them in their portfolio through a fiduciary contract, hence supplementing the portfolio of products of the originating GCC IB with a fiduciary platform covered by the Lebanese fiduciary law. The Lebanese IBs could become the management agents through a fiduciary contract with the GCC IB originator or manager of the Islamic fund.

Chapter 5
Conclusion

This study explores the Islamic financial industry in Lebanon and compares it with its neighboring countries. The study shows excellent opportunities for Lebanon to attract funds from global investors. From our analysis, we could detect several fronts of actions that would project and promote the Islamic finance industry. We conclude that the following are the strategic success factors to increase the volume of Islamic financial operations in Lebanon:

1. **Regulatory framework amendment.**
   The Lebanese banking laws are oriented to protect the depositors' interests. We believe this characteristic to be the founding block of the success of the existing banking sector. In this paper, we suggested several amendments to the existing regulations to adapt to the particularities of the Islamic financial institutions. We detected three basic necessary amendments that would reflect immediately on the operations of IFIs in Lebanon. The first one is the double taxation issue discussed in section 2.3.2 page 20. The law should be adapted to allow a single tax payment on transfer of assets in an Islamic financial operation, as is the case in the UK and in Jordan. The second amendment required is the inclusion of Islamic housing loans in the subsidy bracket. The government subsidizes the "interest" on housing loans. It is required that the subsidy includes "the revenues of an Islamic housing loan". The Lebanese regulator needs to integrate the Islamic Finance concept in its universal banking system. The third one is the regulation of Sukuk issuance. Many investors are oriented to the "capital investment market" for its superior liquidity and ease of operation. In our study, we included several instruments and modes of finance relying on a subsequent Sukuk structure in the prospect that the Sukuk circular will be promulgated before the end of the current year. Furthermore, and in the light of the success of all past

sovereign Eurobond issuances, we believe that the Government would tap into a wider pool of investors when the Sukuk structure is regulated. In fact, the Lebanese sovereign issuances have been oversubscribed and the acceptance of these bonds in the investors' community would reflect on Islamic Sukuks also. We believe this is a key success factor for achieving a substantial level of operations through the Lebanese IFIs.

2. Solidere as an Islamic Financial Hub in Beirut, the "BIFC"

Following the regional tendency of conglomerating the Islamic financial institutions in one single hub, Lebanon needs to consider establishing the Beirut Islamic Financial Center **"BIFC"** in Solidere. The concentration of the major Islamic financial services providers in one central hub will increase the visibility of the industry as a whole. We envisage a master-planned integrated financial community on prime seafront property in Beirut with a diverse range of commercial, residential and leisure facilities. The BIFC will have the following characteristics:

a. It will empower and integrate a sophisticated business community of reputable international, regional and local institutions and business ventures in Lebanon.

b. It will reinforce Lebanon's reputation and visibility as a financial center, linking the Middle East and the GCC region to Europe.

c. It will have a special regulatory status for facilitating the registration and licensing processes for financial institutions.

d. It will accommodate a state of the art architecture, technology, business and lifestyle in one single integral area.

e. It will become the centre of expertise, training, learning and innovation for the Islamic financial community of the area.

f. It will channel Islamic funds and investors through one comprehensive financial service centre, and will boost employment.

g. It will reflect the true essence of Lebanon: a melting pot of cultures, believes and *modus vivendi.*

3. **Special untapped market segments**

A major success factor for promoting Islamic financial services in Lebanon is to explore the untapped market segments. Although Murabaha is the major Islamic mode of finance in Lebanon and in the GCC, the Lebanese IFIs should venture into securitization, privatization, equity funds and microfinance. The Lebanese SME sector will benefit from Mudaraba financing as opposed to conventional high interest rate loans. The rural sectors will benefit from Salam and we explored olive oil exportation as a first candidate for Salam and Parallel Salam with US$250Mn export per annum. Pegging an Islamic Fund to a fiduciary contract is a differentiating characteristic of a product that Lebanese IFIs can offer. Lebanon's need of urgent infrastructure projects is a starting point to finance big volume projects tapping the Islamic Build, Operate and Transfer modalities discussed in section 4.5 page 95. All these market opportunities are attractive to global Islamic investors eager to diversify their portfolio placements and explore new and lucrative markets.

4. **Marketing and communication strategy**

Islamic financial services in Lebanon should address the masses and not only the elite or the religiously aware. A holistic communication approach should be designed to reach all the strata of the Lebanese society. We did not find any cultural shock or reserves during our analysis, yet we could sense a certain degree of interrogative involvement. We believe the Lebanese potential customers need to know the ins and outs of an Islamic deposit and an Islamic "loan". A civil engineer I interviewed expressed his enthusiasm to know more about the Islamic modes of financing his projects. We believe the communication strategy should focus on the uses of Islamic modes of finance rather then on the Sharia mandate of banning Riba alone.

Awareness, attitudes, motivations and perceptions vis-à-vis the Islamic modes of finance should be investigated and included in a nation wide communication strategy.

Lebanon is a potential candidate for an Islamic Financial hub in the region. A 5 year plan considering the success factors mentioned above backed with a national and international awareness strategy will promote and develop further this newborn industry. Now is an adequate time for Lebanon to benefit from the excess liquidity in the region due to high petroleum prices. Lebanon should grab this opportunity while it lasts[83].

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[83] At the date of these closing comments, 07-07-2006, the price of petroleum hit again the historical level of US$75 per barrel.

Appendix A

Basic Islamic financial instruments

Fundamental principals of Islamic finance.

The Islamic financial system broadly refers to financial market transactions, operations and services that comply with Islamic rules, principles and codes of practices. The laws and rules of the religion require certain types of activities, risks or rewards to be either prohibited or promoted. While Muslims undertaking financial transactions are encouraged to use financial instruments that comply with these rules, other investors may find the appeal of these instruments from an ethical standpoint.

Islamic laws and rules are known as Sharia and are also referred to as Islamic jurisprudence. Sharia governs all aspects of Islamic matters including faith, worship, economic, social, political and cultural aspects of Islamic societies. The rules and laws are derived from three important sources, namely the Holy Quran (the holy book of the religion of Islam), Sunnah (the practice and tradition of the Prophet Muhammad p.b.u.h.) and ijtihad (the reasoning of qualified scholars). Further elaboration and interpretation of the rules dictated by the Holy Quran and Sunnah are provided by qualified scholars in Islamic jurisprudence via ijtihad or an interpretative process which is carried out within the framework of Quran and Sunnah.

Modern Islamic financial products and services are developed using two different approaches. The first approach is by identifying existing conventional products and services that are generally acceptable to Islam, and modifying as well as removing any prohibited elements so that they are able to comply with Sharia principles. The second approach involves the application of various Sharia principles to facilitate the origination and innovation of new products and services.

In order to provide a better understanding on the unique attributes of Islamic finance, this Chapter discusses the fundamentals and principles, which form the foundation of Islamic financial services.

Basic principles

Islamic law on commerce is known as fiqh al-mu`amalat. Much of the laws, rules and interpretations of Shariah takes into consideration issues of social justice, equitability, and fairness as well as practicality of financial transactions. In general, the Shariah legal maxim in relation to commercial transactions and contracts state, “they are permissible unless there is a clear prohibition.” In a nutshell, prohibited elements of a commercial transaction must first be removed for it to be Shariah-compliant. The major prohibited elements under Shariah are riba (interest), gharar (uncertainty), maisir (gambling), non-halal (prohibited) food and drinks and immoral activities.

a) Prohibition of riba

Riba has the literal meaning of “an excess” and is defined as an increase or excess which accrues to the owner in an exchange or sale of a commodity, or, by virtue of a loan arrangement, without providing equivalent value to the other party.

More precisely there are two categories of riba – riba qurudh and riba buyu`. Riba qurudh, in its application to modern financial transactions, occurs through loans. The prohibition of riba qurudh relates to any fixed or predetermined rate of return tied to the maturity and the amount of principal (i.e., guaranteed regardless of the performance of the investment). The general consensus among Shariah scholars is that riba covers not only usury but also the charging of "interest" as widely practiced.

However, the lending activities or loans are still allowed in Islam through the concept of Qardh Hasan. This type of lending is a contract of loan between two parties on the basis of social welfare or to fulfill a short-term financial need of the borrower. The amount of repayment must be equivalent to the amount borrowed. It is however legitimate for a borrower to pay more than the amount borrowed as long as it is not stated or agreed at the point of contract.

On the other hand, riba buyu` occurs through the sale and purchase of six riba's commodities (i.e., gold, silver, dates, wheat, barley and salt). The transaction of riba's commodities is required to adhere to the following conditions[84]:

i) In trading commodities of the same group and kind, such as gold for gold or dates for dates; two conditions must be fulfilled, i.e., both commodities must be exactly equivalent and there must be prompt delivery

ii) In trading commodities of the same group but of different kinds, such as gold for silver, or wheat for barley, there is only one condition, i.e., the promptness in delivery is not a condition.

iii) In trading commodities of different groups and kinds, such as gold for wheat, or silver for barley; no condition is imposed and free trading can exist, whether there is equality, inequality, promptness or delay.

Thus, Islam encourages the earning of profits but forbids the charging of interest. Profit symbolizes successful entrepreneurship and the creation of additional wealth through the utilization of productive assets, whereas interest is deemed as a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses. Social justice under Shariah requires borrowers and lenders to share rewards as well as losses equitably and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.

b) Prohibition of activities with elements of gharar (uncertainty)

Gharar is defined as activities that have elements of uncertainty, ambiguity or deception. In a commercial transaction, it refers to either the uncertainty of the goods or price of goods, or deceiving the buyer on the price of goods.

An element of gharar is considered a normal phenomenon in the market if it is not excessive in the contracts and where the effect on the economy and society is considered minimal. This is accepted by Shariah as it would be practically impossible to eradicate this element completely from the market. A large element of gharar in a commercial transaction, on the other hand, is prohibited according to Shariah as it may affect the legality of a transaction.

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[84] OICV-IOSCO; Islamic Capital market fact finding report, July 2004, pp5-9.

One of the examples of gharar in the financial market is in conventional insurance. Shariah scholars are of the opinion that conventional insurance is not Shariah compliant due to the large element of gharar. This is because the policyholder enters into an agreement to pay a certain sum of premium and in turn the insurance company guarantees to pay a certain sum of compensation in the event of disaster. However, the amount of compensation that the company will pay to them is uncertain and it is also dependant on the occurrence of specific events in the future.

c**) Prohibition of maisir (gambling) activities**

Gambling is referred to as qimar or maisir in Arabic, which means any activity that involves an arrangement between two or more parties, each of whom undertakes the risk of a loss where a loss for one means a gain for the other, as it is common for gambling activities. The gain accruing from these games is unlawful in Islam, as it diverts the player's attention from productive occupation, and amassing wealth without effort. It is considered an immoral inducement by the person involved in expecting to make a profit at the expense of another party.

In relation to the above, Muslims are also prohibited from having any affiliation to gambling activities including participating, investing or financing any businesses related to, or associated with, the gambling industry.

d) Prohibition of the production and sale of goods and services that are prohibited in Islam

There are a number of drinks and foods that are prohibited in Islam such as alcoholic beverages and non-permissible food like pork. In addition, there are also prohibitions against immoral services such as pornography, prostitution, immoral entertainment and others. In this context, Shariah scholars are of the view that any activity relating to these products and services such as processing, producing, marketing, supplying and selling are also non-permissible.

Therefore, companies, which are involved in or accrue gains from business activities related to these non-permissible activities, would not be deemed as Shariah compliant.

Basic Shariah principles for Islamic financial products and services

The underlying fundamentals of Islamic financial transactions form the basis of the difference between conventional and Islamic financial instruments. Modern Islamic finance began with the emergence of Islamic banking, where products and services are not based on riba (interest). As the industry grew, many other financial products in the insurance and capital market sectors were adapted to incorporate Shariah compliant aspects. Product innovation has been significant in the Islamic financial services industry over the last decade, resulting in a wide array of Islamic instruments being introduced in the market. Shariah compliance rules have been developed for equity, debt and securitization products and are in the process of being extended to structured products and examined for derivatives as well. Rules to determine Islamic-compliant operations have also been developed for the banking, broking, investment management and advisory services.

Murabaha

It refers to a contract of exchange transaction in which a financial institution purchases goods upon the request of a client, who makes deferred payments that cover costs and an agreed-upon profit margin for the financial institution. It is the most widely used instruments of Islamic finance. It's first of all, a deferred sale, and then, a credit sale.

Murabaha transaction represents 80% of the Islamic transactions, because of:
-the inexistence of important risks.
-the profitability of the operation.
-the relative short term of the transactions.

The Conditions of Validity:
-the Murabaha contract should be Sharia Compliant.
-the bank acquires the goods.
-the Conditions should be defined in the contract: Margin, delivery conditions, payment, terms.

The Different aspects of The Murabaha Deposit product are:
-The Islamic Bank has no exposure to commodity price volatility.
-There is no physical handling of commodities. The transaction involves only paperwork.
-The structure is elegant and easy to execute. It is based upon well established practice in Islamic finance.

The fundamental resources of Murabaha can be commodities, which are widely traded on the London Metal Exchange (LME) (such as, Aluminum, Copper…), or Assets that the Ultimate Borrower is willing to acquire (buildings, materials, shares, machines…).

Comparison with the conventional interest loan:
The Murabaha contract is close to the transaction with interest. To fix his margin, the banker has to benchmark with the current interest rates of his market. The major differences from conventional loans are:
-The margin is an essential remuneration for the incurred risk of the Islamic banks that are owners of the product until the sale is executed.
- The negotiated margin is fixed; it doesn't vary with the payment delay.

The purpose of the Murabaha transaction is to protect the investor's initial capital investment and ensure the minimum return amounts, if any, at maturity.
This is achieved through the purchase and forward sale of the relevant quantity of commodities at a pre-determined price.
The Murabaha mechanism generally involves up to four counterparts.
The parties are:
1-The Islamic Bank: counterparty to the Murabaha. By being the counterparty to the Murabaha, the Islamic Bank is depositing in a Sharia Compliant manner funds for a defined period of time and at a profit agreed on inception day.
2-The Receiving Institution: counterparty to the Murabaha. By being the counterparty to the Murabaha, the Receiving Institution is receiving in a Sharia Compliant manner funds for a defined period of time and at a profit agreed inception day.
It is also the agent of the Islamic Bank: it purchases commodities from its source.

Murabaha transaction:

-The Islamic Bank, through its Agent (i.e. the Receiving Bank) will purchase commodities for spot payment at price P.
-The Receiving Bank shall agree to buy the commodities from the Islamic Bank on deferred payment terms at price P + Margin.
-The Murabaha transaction between the Islamic Bank and the Receiving Bank is structured as an offer and acceptance between the two parties.
-The Receiving Institution will sell the commodities to a commodity buyer on a spot basis at the same price at which the original purchase was executed, i.e. at price P to finally receive the proceeds of the contemplated deposit.
-At the settlement of the deferred commodity purchase (i.e. at the maturity of the deposit), the Receiving Bank will pay the amount owing to the Islamic Bank under the deferred commodity purchase.
-This purchase price is composed of 100% of the Murabaha Deposit and the profit on the transaction (i.e. the profit agreed between both parties and will include the commodities transaction costs).

The Commodities transactions are carried out instantaneously protecting the parties from any exposure (price variation) on the underlying commodities.
And, during the life of the Murabaha Facility, neither the Islamic Bank nor the Receiving Bank, at any time, has to physically deliver or receive the commodities.

Revolving Murabaha:
The revolving Murabaha is an exchange transaction in which a trader purchases items required by an end user on a rolling or revolving basis. It is also, an agreement to enter into a series of Murabaha, one after the other and all for the same estimated amount with the same profit margin. On each rollover date the trader sells those items to the end-user at a price that is calculated using an agreed profit margin over the costs incurred by the trader.

The Revolving Murabaha is basically an agreement for a certain period of time (tenor of the “swap”) between a buyer and a seller to enter into consecutive Murabaha contracts of the same amount (notional) and each for the same period of time (frequency of payments).
Though payment dates and maturity coincide, the Revolving Murabaha is not linked to the Term Murabaha. This means that entering into the Revolving Murabaha is not conditioned to entering into the Term Murabaha.

The Revolving Murabaha distinguishes the initial Murabaha and Anticipated Murabaha contracts where:
-The initial Murabaha and the first Murabaha which shall mature on the same date than the first installment of the Term Murabaha.
-The Anticipated Murabahas are the Murabaha contracts rolled-over an maturing on each subsequent installment of the term Murabaha, and
-The last Anticipated Murabaha shall mature on the maturity date of the Term Murabaha

The profit on each of the Anticipated Murabaha shall be calculated according to Market Profit Rate conditions applying at the time of each roll-over.

Mudaraba:

This is a contract between two parties whereby one part, Rub al Mal (beneficial owner i.e. investor), entrusts money to another party, the Mudarib (managing trustee). The Mudarib is to utilize this money in an agreed manner and then returns at the expiry of the contract to Rub al Mal the principal and the pre-agreed share of profit. The Mudarib will retain any remaining residual funds after settling in full the amounts owing to the Rub al Mal. The Mudaraba is used only in case of a Syndicated Murabaha Facility. It is also the issuing vehicle for the Murabaha facility, and it enters into the revolving Murabaha with the Ultimate Borrower on behalf of the investors.

There are two forms of Mudaraba:

-Limited Mudaraba, when the contract concerns a specific operation.

-Unlimited Mudaraba, when the Mudarib is free to act.

In case of profit: the Mudarib is remunerated for his work and his expertise, and the Rub el Mal (investor) for his capital contribution.

In case of loss: the Mudarib loses his job and Rub el Mal loses his money. If the loss is caused by mismanagement, the loss will be supported by the two parties.

Mudarib

The Mudarib is the managing trustee of the Mudaraba. It assumes responsibility to act on behalf of the investors (if any). He's also described as the labor partner.

The Agent for the Mudaraba or the Lending Institution will buy the pre-determined assets for spot payment at a certain price.

The Ultimate Borrower shall agree to buy the commodities from the Mudaraba on deferred payment terms (1, 2, 3 or 6-months deferral) at price P plus a Margin.

The Murabaha transaction between the Mudaraba and the Ultimate Borrower is structured as an offer and acceptance between the two parties.

The Lending Institution or the Mudaraba, as the agent for the Ultimate Borrower, will sell the commodities held under the Ultimate Borrower's name, to a commodity buyer on a spot basis at the same price at which the original purchase was executed, i.e. at price P.

Parties & Their Roles

The Ultimate Borrower: Counterparty to the Murabaha/Revolving Murabaha.

He is able to make use of the proceeds of the Murabaha Facility. The respective obligations of the Ultimate Borrower and the Mudarib will be subject to a legal contract between the parties.

The Lending Institution(s) are:

-Mudarib or Managing Trustee for the Mudaraba.

-Agent of the Mudaraba for the Murabaha transaction.

-Agent of the Ultimate Borrower for the Murabaha transaction.

-Banker for the Mudaraba for the Murabaha.
-Banker for the Ultimate Borrower for the Murabaha.

Settlement Date of the Deferred Commodity Purchase:
-At the settlement of the deferred commodity purchase (i.e. at the end of 1, 2, 3 or 6 months), the Ultimate Borrower will pay the amount owing to the Mudaraba or the Lending Institution (as the case may be) under the deferred commodity purchase.
-This purchase price is composed of (a) 100% of the Murabaha Facility and (b) the profit on the transaction (i.e. the profit agreed between both parties and will include the commodities transaction costs).

Rollover Mechanism work:
-From Day 1, the Mudaraba/the Lending Institution and the Ultimate Borrower will enter into a rolling Murabaha agreement, effectively committing the two parties to enter into a series of asset transactions on pre-determined dates under deferred purchase terms.
This means that:
-When one Murabaha expires, the two parties agree to enter into a new one on pre-determined terms.
-At the end of the maturity of one Murabaha agreement, i.e. when the deferred purchase price has to be paid, there is netting with the net proceeds of a new Murabaha. The difference between the amount payable under the maturing Murabaha and the amount payable of the new Murabaha equates to the profit expected by the investors/the Lending Institution (plus any costs).
-At the maturity of the final deferred purchase agreement, the Ultimate Borrower will pay to the Mudaraba/the Lending Institution the deferred purchase amount and, in case of a Syndicated Murabaha Facility, the Mudaraba will pass this amount (which equates to the principal amount of the Murabaha Facility plus expected return) to the investors.

-No Exposure to Commodities' Price Risk: The Commodities transactions are carried out instantaneously protecting the parties from any exposure (price variation) on the underlying commodities and allowing the Ultimate Borrower to receive the proceeds of the facility instantly.

-No Need for Physical Settlement means that during the life of the Murabaha Facility, the Ultimate Borrower doesn't, at any time, have to physically deliver or receive the commodities.

Periodic Settlement of Murabaha: At the settlement of each Murabaha, the margin accumulated by the Mudaraba is directly transferred to the investors, thus ensuring that investors get their periodic return.

Key Documentation: The main documents to be executed by The Ultimate Borrower are Murabaha/Revolving Murabaha (between the Mudaraba/the Lending Institution and the Ultimate Borrower) and Agency Agreement (between the Murabaha/the Lending Institution and the

Ultimate Borrower) to facilitate the handling of the commodity trades under the Revolving Murabaha.

Musharaka (active partnership)

This is a partnership, normally of limited duration, formed to carry out a specific project.
It is therefore similar to a joint venture, and is also regarded by some as the purest form of Islamic financial instrument, since it conforms to the underlying partnership principles of sharing risks and benefiting from a "commercial" activity. The profits are divided on a predetermined basis.
Equity Participation or Musharaka: The bank or the agent offers money to create a new project or to participate in an old one. Sharing profits is indirect proportions to each partner's contribution, so that everyone becomes owner relative to his contribution.
The participation can be either fixed or digressive within the associated legal framework.
Musharaka Sabita (Fixed participation): it's the participation where the part of participant stays in the capital for the period of time that is intended in the contract.
Musharaka Moutanakissa (The participation leading to acquisition): the bank gives the right to the participant of other participants to buy progressively shares from the bank. So the parts of the bank will get smaller and the one of the participants bigger. At the end, the participants will be the sole owners of the project.

Advantages of this financial mode:

For Islamic banks:
- Investing the liquidities at long or mid-term.
- Regular source of revenue, in opposition with product that procure punctual resources.
- Adapted formula for co-financed project.

For the firm:
- The financial cost is a function of the result.
- It permits to an entity lacking collaterals and guaranties, to develop itself.

Bai Al Salam

Al Salam is essentially a transaction whereby two parties agree to carry out the sale and purchase of an underlying asset at a future date but, at a price determined and fully paid for today. The seller agrees to deliver the asset in the agreed quantity and quality to the buyer at a future date. This is similar to the conventional forward contract. However, the principal difference is that in an Al Salam sale the buyer pays the entire amount in full at the time the contract is initiated (as opposed to a premium in a forward contract).
Usually, Al Salam is used for agriculture goods.
Some particularities:

-Possibility for the Islamic bank to set some guaranties in the contract to protect itself from: a delivery fault at the expiration or a non-payment by the end buyer.
-The seller's remuneration is a commission or participation to the sale margin

Conditions of validity:
-The purpose of the contract should be clear (nature, quality, value…).
-The delivery delay and the delivery place should be fixed.
-The price should be set and paid cash by the buyer.

Ijara (leasing)

Ijara is an Arabic term for leasing. It has its origin in Islamic Fiqh, and literally means to rent an asset for consideration.
The Islamic bank buys an asset and rents it to a firm for a determined period of time.
The renting price is spread over the contract period. It can be reevaluated during the contract. At the end of the contract, the renter might decide to acquire the good.

Particular case: Ijara Wa Iktina (renting- sale)
The client engages in paying the rental in an investment account, which will eventually help him to buy the product.

Ijara Head Lease Agreement: the issuing Vehicle (as the lessee) and the Ultimate Borrower (as the lessor) shall, in respect to the tangible assets, enter into an Ijara Head Lease Agreement which is in fact a long hold lease (up to 99 years). In respect to this Agreement, the Issuing Vehicle shall be asked to pay the advance Rental to the Lessor. (i.e. the ultimate borrower). This Advance Rental Amount shall correspond to the nominal amount of the issue.

Ijara Sub Lease Agreement: as per the Ijara Head Lease Agreement, the Issuing Vehicle shall have the full usufruct of the selected Tangible Asset. In this regard it has the right to sub-lease these tangible assets. The issuing vehicle (lessor) shall enter into an Ijara Sub-Lease Agreement with the ultimate borrower (lessee).

Istisna'a:

It is a sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser. If the manufacturer undertakes to manufacture the goods for the purchaser with materials from the manufacturer, the transaction of Istisna'a comes into existence. But it is necessary for the validity of Istisna'a that the price is fixed with the consent of the parties and that the necessary specifications of the commodity (intended to be manufactured) is fully agreed upon between both parties.
The contract of Istisna'a creates a moral obligation on the manufacturer to manufacture the goods, but before he starts the work, any of the parties may cancel the contract after giving a noticing the other. However, after the manufacturer has started the work, the contract cannot be cancelled unilaterally.

The difference with Al Salam:
Keeping in view this nature of Istisna'a, there are several points of difference between Istisna'a and Salam which are summarized below:
- The good doesn't exist at the creation of the contract.
- The subject of Istisna'a is always a good that needs manufacturing, while Salam can be affected on anything, no matter whether it needs manufacturing or not.
- In Salam contract, the price is paid in advance, while it is not obligatory in Istisna'a contracts.
- The contract of Salam, once affected, cannot be cancelled unilaterally, while the contract of Istisna'a can be cancelled before the manufacturer starts working.
- The time of delivery is essential in Salam, while it's not the case in the Istisna'a.

Istijrar

It means purchasing goods from time to time in different quantities. In Islamic jurisprudence Istijrar is an agreement where a buyer purchases something from time to time; each time, there is no offer or acceptance or bargain. There is no master agreement where all terms and conditions are finalized.
In order to finance the production of future commodities, the purchaser will provide an advance payment to the seller.
The purchaser and the seller will enter in this respect into an Istijrar contract. Under such Istijrar, the seller will undertake to supply to the purchaser in proportional installments on pre-agreed dates some commodities, whose quality and sale price calculation will be fixed in advance.
Prior to each delivery date, the purchaser will determine a certain quantity to be delivered according to a price formula, defined from the first day. The purchaser will appoint a commercial agent to handle the commercial operations related to the receipt and delivery of commodities.
In parallel the purchaser will enter into a parallel Istijrar with off-Takers/beneficiaries at a determined. Upon receipt of the deliveries of the contemplated quantity, the commercial agent will then deliver it to the Off-Takers.
The purchaser will receive proceeds of the sales under the parallel Istijrar including a profit that will be adjusted amount equivalent to the repayment of the contemplated facility

Joa'ala:

It's a transaction whereby a client approaches a bank to make a service demand, and pays in return a specific sum as administrative costs.
The service demand may be:
-Advising
-Services
-Funds placement
-Etc.

Sukuk:

It represents a proportionate beneficial ownership in an asset. For a determined period, the return associated with the cash flows generated from the assets belongs to the Sukuk holder. The characteristics of a Sukuk are therefore similar to a conventional bond with the difference being that they are asset-backed. However investors will have no real exposure in terms of risk or liability on the underlying assets but, they will only be exposed to an Islamic Bank Credit Risk.
Sukuk are Bonds emitted by the Islamic Bank to finance public or private projects. Sukuk is the youngest product of the financial Islamic products. This product should interest countries with big public deficit.

History and development

-Malaysia begin the Sukuk emission in 2002, followed by Qatar and Bahrain

-The first Sukuk emission of the **Islamic Development Bank** (**IBD**) was in July 2003 (400 millions dollars)

-The second Sukuk emission of the **Islamic Development Bank** (**IBD**) was in May 2005 (1 billion dollars)

-In July 2004, launching of the first Islamic bund emission in the European Union: 100 millions euros, due date: 3 years, emitted by the State of Saxe-Anhalt

This State puts on bonds market through the company (Citigroup).

The target public: countries members of GCC (Golf Cooperation Committee).

The funds finance the purchase of real estate. Then, the products are resell through different ways (Murabaha, Mudaraba, Bai Salam, Istisna'a', Ijara, etc).

A-Mixed Assets Sukuk:

It's an instrument or a security (Sukuk) representing beneficial ownership of the underlying Assets: evidenced by Ijara (Long-Term Leases) contracts (and the related underlying Assets), between the Mudaraba (i.e. the SPV) and the ultimate issuer (i.e. The Islamic Bank), and the Murabaha receivables (installment Sale). Periodic returns payable to Sukuk Holders are sourced from the profits earned on the underlying Ijara/Long-Term Leases (i.e. rents) and Murabaha Receivables (installment Sale). Such returns are paid on pre-determined dates, usually on a semi-annual or a quarterly basis.
In term of structure, the Mixed Assets Sukuk is very close to the Ijara version. From a Sharia perspective, it is also a widely accepted format of Sukuk among scholars

Different phases:

-The Islamic Bank sells beneficial title (and not the legal property) of a selected pool of Assets to the SPV. The SPV being beneficial owners are entitled to the return generated by the Assets.

-This pool of assets shall be composed of 51% of Leased Tangible Assets and 49% of Murabaha receivables.

-The SPV funds the acquisition through issuing Sukuk for nominal value to Islamic investors.

-The SPV agrees to pay the investor a certain return.

-In case of mismatch of the return of the Asset and the return on the Sukuk, an interest-free lending/credit line will be set up by the Islamic Bank in favor of the SPV.

-At maturity the Islamic Bank buys the Assets back from the SPV for the nominal value.

-The SPV distributes the Principal back to the investors.

Two kinds of Assets shall be brought to the SPV: tangible Assets in the proportion of 51% and Murabahas (receivables) in the proportion of 49%.
If the Islamic Bank has no Sharia-compliant receivables to bring, then the SPV and the Islamic Bank will enter into an International Commodity Murabaha agreement (loan) with same maturity than the Sukuk.

International Commodity Murabaha:
The SPV buys commodities on the market; then sells them to the Islamic Bank on installments at the purchase price plus a margin. In order to get the proceeds, the Islamic Bank appoints the SPV as its agent to be in charge to sell the commodities at the purchase price.

B-Sukuk al Ijara: it is the most accepted format of Islamic bond among scholars

Different phases:

-The Islamic Bank sells beneficial title (and not the legal property) to a selected Assets to the SPV at nominal value
-The SPV funds the acquisition through issuing certificates of participation (Sukuk) for nominal value to Islamic investors
-The SPV leases the asset back to the Islamic Bank and the SPV receives rent from the Islamic Bank
-The investors as beneficial owners are entitled to the rent received from the Islamic Bank
-At maturity, the Islamic Bank buys the Assets back from the SPV for the nominal value
-The SPV distributes the Principal back to the investors

Any kind of tangible asset can be owned by the Islamic bank such as lands, buildings, warehouses (ports, airport…) preferably assets with a low depreciation rate.

The right of the SPV and the Sukuk holders over the Assets: SPV hold beneficial title to the assets that is held on trust for the investors who each owns a proportion of the beneficial interest in the Assets. Therefore, during the life of the Sukuk, the SPV cannot dispose (sell or alter) of the Assets. The title is transferred back to the Islamic Bank at maturity.
In case of litigation, the SPV is dissolved and obligations of Islamic Bank will rank pari passu with its senior, unsecured debt obligations.

C-Sukuk al Intifah:

It is very comparable to Sukuk Al Ijara, regarding its documentation, its structure management during the life of the Sukuk, and the tradability of the instrument. The main difference with Sukuk Al Ijara format is that there is no legal transfer of Tangible Assets to the issuing vehicle, the assets are transferred to the Issuing Vehicle and, Assets are sub-leased back to the legal owner (i.e. Islamic Bank)

D- Sukuk al Musharaka:

It's the easiest and most convenient type of Sukuk in case of Real Estate projects.

Different phases:

-An SPV held by charitable trust shall issue Sukuk to enter into a Musharaka Agreement with the Islamic Bank in order to develop a specific project or activity (i.e. construction of a building…)
-Each partner shall provide the Musharaka with a contribution (Sukuk proceeds for the SPV, land for instance for the Islamic Bank), receiving in return Units of the Musharaka.
-The profit shall be distributed under a pre-determined split with a cap fixed for the return perceived by the SPV, at the level of return paid by this latter to the investors on the Sukuk (i.e. cap at Libor + X%)
-The Islamic Bank in its quality of Management Agent shall be in charge of distributing the money received through the Musharaka to both Musharik and shall receive the potential surplus as performance fees.
- The Islamic Bank, under a Purchase Undertaking agreement, shall have the possibility, when needed, to buy part of SPV's Units.

E- Sukuk Al Salam: Al Salam is a transaction where two parties agree to carry out the sale and the purchase of an Underlying Asset to be delivered at a future date but at a price determined and fully paid on the day the contract is entered into.
The Bahrain Monetary Agency issues Sukuk Al Salam on a monthly basis since June 13th 2001.

Different phases:

-The Islamic Bank designates an underlying Asset (aluminum, Oil…)
-The SPV makes a full payment of the Asset against future delivery of these assets
-At maturity date or on delivery sated, the Islamic Bank will deliver the asset to the SPV
-The Al Salam contract will provide a parallel Salam that will be set up whereby; Off-Takers (entity related to Islamic Bank) will buy back these Assets at price that will have been pre-agreed in the Salam.
-This way, the investors won't be exposed to the price volatility of the underlying Assets
-The Risk for the investors is an exposure on the Islamic Bank
-The difference between the purchase price (Salam) and the Selling price (parallel Salam) is the margin to the Investors

Any kind of Sharia-compliant asset as long as it is standard, quantifiable, and which quality can be determined such as oil, aluminum or other commodities, can be contemplated.
The Sukuk Al Salam structure is a well-accepted structure for short-term money market instrument. On a longer term, this structure still has to be tested as tradability for such an instrument is not accepted from Sharia purposes.
The Off-price (or selling price) being fixed at launch the Sukuk Al Salam is by essence a Fixed rate coupon instrument. However, like the Ijara Sukuk, Floating rate coupon can be achieved by the parties entering a Al Salam contract on periodic dates.

F- Sukuk Al Murabaha:

Based on a Murabaha, Sukuk al Murabaha is one of the easiest types of Sukuk in term of documentation and structure management during the life of the Sukuk.
The main difference with Sukuk Al Ijara is that there is no need for any transfer of Tangible Assets, being based on Murabaha contracts, such an instrument cannot be traded as Murabaha contracts, it can only be traded at Sharia perspective, and tradability isn't accepted for Sharia purposes.
This format is an easy type of Sukuk in terms of structuring effort for an Islamic bank, as it doesn't require any tangible Assets; the Murabaha contracts being based on an exchange of international commodities purchased on the London Metal Exchange.

G-Securitization Sukuk

It is the "Issuance of Islamic securities backed by Islamic financial assets".
The Asset backed securities will not be Sharia-compliant even if the underlying assets are Sharia-compliant. Indeed, the notes issued, backed by Islamic contracts, if traded, would be considered as a from of debt trading prohibited under Sharia law.
In order to issue tradable Sharia-compliant notes, a certain amount of tangible Assets (lands, commodities…) shall be brought in, in order for the special Purpose Vehicle's balance sheet to be composed of 49% of Murabaha contracts and 51% of tangible Assets.
The SPV will buy tangible Assets. Those assets will represent at least 51% of the total Assets of the SPV. The Sukuk will be issued by a "Mudaraba" (SPV). The issuer will then act as a "Mudarib" investing the funds on behalf of the Sukuk Holders in the "Finance Company's" shares. In case of Lands & Buildings, Tangible Assets will not be funded by the proceeds of the Sukuk. Their purchase price by the SPV will be settled by installments, they will be leased back to their seller and the lease rents will be equal to installments.

Specificities of the securitization instrument

Though the Assets are transferred, the Islamic Bank will remain the Servicer (i.e. responsible for the collection of the sums to be received from the Murabaha Receivables or generated by the Tangible Assets) and therefore will retain the commercial relationship with each customer under the Murabaha Receivables
The exposure for Sukuk Holders, in the case of securitization deal, is on the portfolio as opposed to the Islamic bank itself in the case of a Debt Capital Market Sukuk issue, i.e. the return for the Sukuk Holder is based on the quality and performance of the portfolio and the Sukuk Holder is based on the quality and performance of the portfolio and the Sukuk Holders are entitled to a part of margin on the portfolio and not a "coupon" from Islamic Bank. In case no default occurs on the portfolio, the margin on such Underling shall be greater then the return on the Sukuk; therefore, this excess shall be returned to the Islamic Bank, acting as Servicer, in the form of a performance Fee.
In case Underlying Murabaha/Ijara contracts have a shorter tenor then the Sukuk, the portfolio will have to be replenished with new contracts using specific selection criteria.

Qard Al Hassan (credit without interest)

Those are credits without compensation, done for a humanitarian purpose, or charity. The aim is the social and economic development. It could be finance through over drought.
Characteristics:
-Occasionally granted for persons in need, clients in need of money…
-The bank can make the borrower pay fees that cover administrative cost.
-It can be transformed to a participation in the company's capital which borrows.
-It can be use to develop projects in social, economical, religious, or educative field.

The credit can be rigid (the amount and the repayment are fixed) or, flexible (the amount and the repayment are variable).
The Funds can originate in charity or in Zakat's funds. Those credits are a demonstration of Islamic bank's social strategy. We can estimate the amount of those loans, as 1% of Islamic bank's transactions.

The Tafseel Structure:

The Tafseel contract is an innovative and flexible approach to structure products, designed to be run in accordance with Islamic principles. Against the payment of a "capital contribution", the bank is to deliver investors a certain return, within a Sharia-compliant structure. Within this framework, complex payoffs can be structured to fit investor's needs. Tafseel contracts are ideally suited to providing leveraged exposure to underlying Assets and capital protection if required.
It's specially designed to provide a flexible framework under which a range of asset-linked derivative payoffs can be constructed in accordance with Sharia investment principles.
In respect of each Tafseel Transaction, the Counterpart pays to the bank at inception, a capital contribution plus a nominal fee, in order to receive at maturity a certain asset- linked return.
The bank will invest the capital contributed by the Counterpart in the selection of underlying Assets and will hold these Assets in an identifiable portfolio associated to the transaction.
The bank will then manage the portfolio according to a quantitative mechanism in order to ensure that its value will converge to the agreed return level at maturity.

Appendix B

Laws and circulars regulating the Islamic Financial Industry in Lebanon

Law No 575 dated February 11, 2004
The Establishment of Islamic banks in Lebanon

Single Article:
The draft law included in the Decree No 9351 of December 27, 2002, relating to the Establishment of Islamic banks in Lebanon is adopted as amended by the Commission of Finance and Budget. This law shall enter into force upon its publication in the Official Gazette.
Baabda, February 11, 2004
Signed: Emile Lahoud
Promulgated by the President of the Republic
The President of the Council of Ministers
Signed: Rafic Hariri
The President of the Council of Ministers
Signed: Rafic Hariri

Law on the Establishment of Islamic Banks in Lebanon

Article 1: Islamic banks are the banks whose Articles of Association comprises an undertaking not to contravene, in the operations they carry out, the provisions of Islamic Law (Sharia), particularly with the prohibition to pay or receive interest. Unless otherwise specified in this Law, Islamic banks shall be governed by all legal and regulatory provisions in force in Lebanon, particularly those relating directly or indirectly to banks, including the Code of Commerce, the Code of Money and Credit and the Banking Secrecy Law.

Article 2: The establishment of an Islamic bank or a foreign Islamic bank's branch in Lebanon requires an authorization from the Central Council of the Banque du Liban. The Central Council of the Banque du Liban shall prescribe a special regulation comprising all the conditions required to the granting of such an authorization. The Central Council of the Banque du Liban grants its authorization when deemed serving the public interest. The Council has discretionary power in granting or refusing the authorization and its decisions are not subjected to any ordinary or extraordinary recourse, whether administrative or judicial, including the recourse for excess of power. Non-Islamic banks operating in Lebanon may establish or take part in the establishment of Islamic banks and may hold shares in Islamic banks established in Lebanon, provided they:
1- Obtain a prior approval from the Central Council of the Banque du Liban; and
2- Comply with the provisions of Article 153 of the Code of Money and Credit.

Article 3: Islamic banks are entitled to offer and provide all banking, commercial, financial and investment services and operations, including the establishment of companies and the participation in established projects or projects under establishment.
Unless agreed with the client to link its deposits to the bank's annual results or to the results of the operations according to a procedure set for this purpose by the Central Council of the Banque du Liban, cash deposits received by Islamic banks are governed by the provisions of Article 307, Par. 1 and 2, of the Code of Commerce, and by the provisions of Section 2 of Law 28/67 of May 9, 1967. Deposits received in accordance with Article 3, Par. 2, of this Law, and in accordance with Article 307, Par. 1 and 2, of the Code of Commerce, should have a minimum term of six months. However, Islamic banks may open current accounts in the names of their clients for recording cash deposits and withdrawals, securities purchase and sale operations, and other Islamic banking operations.

Article 4: Islamic banks are exempted from complying with the provisions of Article 152, Par. 1 and 2, of the Code of Money and Credit. They are authorized to take participations or share ownerships without being bound by the provisions of Article 153 of the said Code, provided they use either their own capital or the deposits governed by Article 307, Par. 1 and 2, of the Code of Commerce with their owners' written approval.
The Central Council of the Banque du Liban issues the special regulations governing each and all the operations of Islamic banks. The Council determines and modifies also, whenever it deems necessary, the working rules of these banks and the ratios required between balance sheet and off-balance-sheet items which must be maintained by Islamic banks in order to achieve their objectives, protect their depositors and clients, and safeguard their liquidity and solvency.

Article 5: In addition to real estate rights that commercial banks may acquire, and notwithstanding the provisions of the Law implemented by Decree No 11614 of January 4, 1969, and its amendments (on ownership of real estate rights by non-Lebanese in Lebanon), Islamic banks may acquire real estate rights exclusively for investment projects. The acquisition is done by virtue of the prior authorization of the Central Council of the Banque du Liban, which must verify the seriousness of the project and fix in its authorization the time-frame for its execution, provided the said rights are acquired for a non-renewable period not exceeding twenty-five years and are within the limits of the maximum areas authorized for acquisition by non-Lebanese in each District (Mohafaza). The authorization shall not become effective before the approval of the Council of Ministers.

Article 6: Investments and placements in Lebanon must account, at least, for 50% (fifty per cent) of the assets and rights included in the balance sheet items of each Islamic bank.
The Central Council of the Banque du Liban is entitled, in conformity with public interest requirements, to increase the above-mentioned ratio and to decide whether certain balance sheet items are included therein or not. In this matter, the decision of the Council is not subject to any

ordinary or extraordinary recourse, whether administrative or judicial, including the recourse for excess of power.

Article 7: The Islamic banks must inform their clients, notably the owners of result-linked deposits, in writing and periodically every three months at least, of the kind, nature, risks and results of the operations and investments they undertake, as well as of the size of their direct or indirect participation in such projects.

Article 8: Islamic banks must keep their clients accounts in a manner that separates the deposit accounts, opened according to Article 307, Par. 1 and 2, of the Code of Commerce, from the result-linked deposit accounts, opened according to Article 3, Par. 2, of this Law.
The Banking Control Commission at the Banque du Liban shall ascertain that the bank is complying with this obligation. The provisions of the Banking Secrecy Law of
September 3, 1956 cannot be opposed to the Banking Control Commission in the exercise of these functions.

Article 9: The Constituent Assembly of each Islamic bank and, thereafter, the Ordinary General Assemblies, appoint, for a renewable three-year period, a consultative body consisting of three experts in Islamic Law and doctrine, and in banking and financial operations. The consultative body opines about the bank's compliance, in its operations, with the prescriptions of Islamic Sharia. For this purpose, it shall submit a report to both the Board of Directors and the Shareholders' General Assembly. The consultative body may, on its own initiative, submit to the Shareholders' General Assembly and the Board of Directors any proposal it deems useful for properly achieving the bank's object pursuant to the prescriptions of the Sharia.

Article 10: This Law shall enter into force upon its publication in the Official Gazette.

BANQUE DU LIBAN
Circulaire de base No. 94 adressée aux banques

Veuillez trouver ci-joint une copie de la Décision de base No. 8828 du 26 août 2004, relative au fonctionnement des banques islamiques au Liban.
Beyrouth, le 26 août 2004
Le Gouverneur de la Banque du Liban
Riad Toufic Salamé

Banque du Liban
Décision de base No. 8828
Relative au fonctionnement des banques islamiques au Liban

Le Gouverneur de la Banque du Liban,
Vu les dispositions du Code de la Monnaie et du Crédit,
Vu les dispositions de la loi 575 du 11 Février 2004, relative à l'établissement des banques islamiques au Liban, notamment celles des articles 3 et 4,
Vu la Décision adoptée par le Conseil Central de la Banque du Liban en sa séance du 25 août 2004,
Décide ce qui suit :

Article 1: Sur base des dispositions de l'article 3, alinéa 2 de la loi 575 du 11 Février 2004, relative à l'établissement des banques islamiques au Liban, les principes suivants seront adoptés pour établir les contrats et déterminer les rendements des comptes de dépôts pouvant être reçus par les banques islamiques, et qui sont liés aux résultats annuels de la banque ou aux résultats des opérations.

I- Établissement du contrat de dépôt:
Le contrat de dépôt doit, au moins, comprendre expressément les éléments suivants:
- Le montant déposé auprès de la banque concernée, les conditions de son utilisation et sa date d'échéance.
- La part de bénéfice qui revient à chaque partie et qui doit être sous forme de pourcentage indivis et non un montant déterminé.
- Tous les frais encourus par le procureur de fonds (Rab al-Mal).
- Les modalités de répartition des pertes éventuelles.
- La possibilité ou non pour le déposant de retirer le dépôt avant son échéance, en totalité ou en partie, et les conditions d'un tel retrait.
- La possibilité ou non d'intégrer le dépôt aux fonds propres de la banque ou aux fonds dont la banque peut disposer sans restriction.

II- Rendements des comptes de dépôts:
1- En ce qui concerne les dépôts liés aux résultats annuels de la banque:

Les résultats du dépôt sont liés aux résultats annuels de la banque lorsque le contrat de dépôt stipule que ledit dépôt est intégré aux fonds propres de la banque ou aux fonds dont elle peut disposer sans restriction (comptes courants ou autres fonds qui n'ont pas été reçus par la banque sur base d'un contrat de Mudaraba).
Par conséquent, le dépôt lié aux résultats annuels de la banque prend soit la forme d'un compte d'investissement absolu, soit la forme d'un compte d'investissement conditionné intégré.
2- En ce qui concerne les rendements liés aux résultats des opérations:
Les résultats du dépôt sont liés aux résultats des opérations y afférant lorsque le dépôt n'est pas intégré aux fonds propres de la banque ou aux fonds dont elle peut disposer sans restriction, et est, par conséquent, inscrit hors bilan. Dans ce cas, le dépôt prend la forme d'un compte d'investissement conditionné non intégré.
3- En ce qui concerne l'application des parts des résultats:
La part due aux déposants est appliquée d'une manière périodique ou annuelle en fin de période financière convenue, sur base de la valeur comptable (solde inscrit dans les livres de la banque).

Article 2: La valeur de l'actif fixe destiné à être utilisé par la banque islamique ne doit pas dépasser 30% de ses fonds propres de base nets. De même, ses investissements en actif fixe ne doivent pas dépasser, y compris le pourcentage susmentionné, 50% de la valeur totale de son portefeuille d'investissement.

Article 3: Les fonds propres de base nets d'une banque islamique ne doivent, à aucun moment, être inférieurs à 5% de la valeur totale de son portefeuille d'investissement, telle qu'inscrite hors bilan.

Article 4: En plus des réserves légales imposées aux banques non islamiques, la banque islamique doit constituer des provisions «comptes de dépôts liés aux résultats» contre les risques propres aux investissements dans ces comptes, et ce afin de couvrir toutes pertes supérieures à la totalité des bénéfices de l'investissement durant une année déterminée. Ces provisions seront prélevées à un taux égal, au moins, à 12% des bénéfices nets de l'investissement sur les différentes opérations effectuées durant ladite année, jusqu'à ce que la somme cumulée atteigne le double du capital versé de la banque islamique libanaise, ou le double du capital affecté à l'agence de la banque islamique étrangère.

Article 5: Dans ses opérations de financement, la banque islamique devra se conformer aux obligations supplémentaires suivantes:
1- Dans les cas qui requièrent une garantie de la part des clients, le volume du financement ne doit pas dépasser 60% des garanties réelles telles qu'évaluées par les experts de la banque sous leur responsabilité personnelle.
Sont exclues de ce pourcentage les opérations de financement garanties par des dépôts en espèces ou par des garanties bancaires données comme gage ou affectées comme sûreté.
En cas de baisse de la valeur de la garantie, pour quelque cause que ce soit, la banque doit immédiatement réclamer au client des garanties supplémentaires, afin de se conformer au pourcentage susmentionné.

2- Le financement par la banque de l'ensemble des sociétés qui lui sont affiliées ne doit pas dépasser 30% de ses fonds propres de base, et le financement par la banque d'une seule société ne doit pas dépasser 10% desdits fonds.
Ces deux pourcentages couvrent les opérations de financement des fonds communs de placement, qui sont établis et/ou gérés par la banque concernée sous quelque système que ce soit.

Article 6: En sus des dispositions de la présente décision, et sauf stipulation contraire, les banques
Islamiques sont régies par toutes les dispositions et réglementations relatives aux banques non islamiques.

Article 7: Cette Décision sera publiée au Journal Officiel et entrera en vigueur dès sa promulgation.

Beyrouth, le 26 août 2004
Le Gouverneur de la Banque du Liban
Riad Toufic Salamé

BANQUE DU LIBAN
Basic Circular No 95 addressed to Banks

Attached is a copy of Basic Decision No 8829 of August 26, 2004 relating to the conditions for the establishment of Islamic banks in Lebanon.

Beirut, August 26, 2004
The Governor of the Banque du Liban
Riad Toufic Salamé

BANQUE DU LIBAN
Basic Decision No. 8829
Conditions for the Establishment of Islamic Banks in Lebanon

The Governor of the Banque du Liban,
Pursuant to the Code of Money and Credit,
Pursuant to Law No 575 of February 11, 2004 relating to the Establishment of Islamic Banks in Lebanon, notably the provisions of Article 2 thereof, and,
Pursuant to the Decision of the Banque du Liban Central Council taken in its meeting of August 25, 2004, decides the following:

Article 1: Islamic banking activities in Lebanon are prohibited unless carried out by the following institutions:
- The Islamic banks established in Lebanon.
- The branches of foreign Islamic banks.

Article 2:
a- Banks operating in Lebanon or foreign banks, Islamic or proficient in Islamic banking operations, must be among the founders of any Islamic bank in Lebanon.
b- At least one third of a Lebanese Islamic bank's total shares must, at all times, be held by banks from the categories specified in Paragraph (a) of this Article.

Article 3: The minimum capital of Islamic banks in Lebanon or the minimum capital which must be appropriated to branches of foreign Islamic banks licensed to operate in Lebanon is set at LBP 150,000, 000, 000 (one hundred and fifty billion Lebanese pounds), to be fully paid up in cash at the Banque du Liban. Before the start of operations, a proportion of this capital, set by the Central Council, shall be put in escrow at the Lebanese Treasury in the name of the concerned bank, and shall be refunded to the said bank with no interest in case of liquidation of its activities. In justified exceptional cases, notably when the license-requesting banks enjoy high professional standards, the Central Council may, in accordance with conditions it specifies, decide:

1- To grant the Lebanese Islamic bank or the foreign Islamic bank's branch a specified time limit for increasing its capital to the above-mentioned minimum; or

2- To approve a minimum capital of thirty billion Lebanese pounds, in case the following conditions are cumulatively met:

a- The shareholders' equity does not fall, at any time, under LBP 150 billion for:

-The banks contributing to the capital of the Lebanese Islamic bank and which are mentioned in Article 2, Paragraph (a) of this Decision.

-The foreign Islamic bank licensed to open a branch in Lebanon.

b- Each of the banks specified in Article 2, Paragraph (a) of this Decision or the foreign Islamic bank licensed to open a branch in Lebanon expressly undertakes, jointly and severally, and in accordance with the provisions of Article 134 of the Code of Money and Credit, to reconstitute the capital of the Lebanese Islamic bank, or that appropriated to the foreign Islamic bank's branch in Lebanon, in case such capital incurs losses.

Article 4: The license application for establishing a Lebanese Islamic bank must be submitted to the Banque du Liban, signed by the founders, together with an original and three copies of each of the documents specified in Article 2 of Basic Decision No 7739 of December 21, 2000 relating to the Conditions of Establishment of Banks in Lebanon.

The By-laws of Lebanese Islamic banks must include a special section on the Sharia Consultative Body, detailing the provisions that govern the appointment of its members, its relationship with the bank itself and its prerogatives, including the provisions related to Sharia - based internal control. Such provisions should clearly show the compliance of the bank, in all its transactions and operations, with the Sharia provisions and principles that are consistent with the enacted laws not in conflict with the provisions of Law No 575 of February 11, 2004, relating to the Establishment of Islamic Banks and with the regulations issued by the Banque du Liban for the implementation of this law.

Article 5: The license application for the establishment of a branch of a foreign Islamic bank must be submitted to the Banque du Liban, signed by the administration of the concerned foreign Islamic bank, together with an original and three copies of each of the documents specified in Article 3 of the above-mentioned Basic Decision No 7739 of December 21, 2000, in addition to an undertaking issued by the Board of the foreign Islamic bank or its Manager in Lebanon acknowledging the commitment of the said branch to implement the provisions of Article 4, Paragraph 2, of this Decision.

Article 6: The Banque du Liban Central Council grants the license for the establishment of the bank to the extent it deems it serving the public interest and after checking that all the legal and regulatory requirements stipulated in Article 4 of the above-mentioned Basic Decision No 7739 are met.

Article 7: The Lebanese Islamic bank or the branch of a foreign Islamic bank licensed by the Banque du Liban Central Council must complete its establishment formalities within a maximum six- month period from the license notification date under penalty of license cancellation.

Article 8: In addition to the provisions of this Decision, Islamic banks are governed, unless otherwise provided for, by all legal and regulatory provisions concerning non-Islamic banks.

Article 9: This Decision shall be published in the Official Gazette and shall enter into force upon its issuance.

Beirut, August 26, 2004
The Governor of the Banque du Liban
Riad Toufic Salamé

BANQUE DU LIBAN
Basic Circular No 96 addressed to Banks

Attached is a copy of Basic Decision No. 8870 of October 20, 2004, relating to Murabaha operations carried out by Islamic banks.

Beirut, October 20, 2004
The Governor of the Banque du Liban
Riad Toufic Salamé

BANQUE DU LIBAN
Basic Decision No 8870
Murabaha instrument regulation

The Governor of the Banque du Liban,
Pursuant to the Law of currency and credit notably article 70 thereof,
Pursuant to the Law No 575 of February 11, 2004 relating to the Establishment of Islamic Banks in Lebanon, notably Article 4 thereof;
Pursuant to Law No 8828 of August 26, 2004 relating to the functioning of Islamic banking in Lebanon
Pursuant to the Decision of the Central Council of the Banque du Liban, taken in its meeting of October 10, 2004,
Decides the following:

Article 1: definitions
For the purpose of applying the provisions of this Decision, the following expressions shall mean:

Murabaha: it's an exchange transaction between a buyer and a seller. The price is calculated using an agreed profit margin over the costs incurred by the trader.

Amer client or order giver client: the client of Islamic bank

Ma'mour, order taker: the Islamic bank

Assets: it's all the fixed and movable assets that respect the conditions of the article 5 of the law 575 of February, 11th 2004, subject to the Murabaha transaction.

Murabaha of the person who orders to buy: Murabaha is an exchange transaction between two parties or more and they promise to apply this agreement in which the client asks the bank to buy

for him an asset. Then the client buys it from the bank which gets a benefit from it, provided, they sign a contract of sale after the provider acquires the property of the asset.

Deposit/down payment: it's the amount that the buyer pays to the seller to be sure that he is serious in his demand. So by this way, if the buyer is obliged to stop the purchase of the asset, he'll compensate the loss of the bank. If the deposit doesn't cover all the loss that is incurred by the bank, the client will be obliged to pay the rest of the amount. In the same way, if the deposit exceeds the loss amount, the Islamic bank should give back the rest of the deposit to its client.

Available funds for Murabaha operation: it's all the assets for Murabaha's operations

Available funds for Murabaha operation unexecuted: it's all the assets that were kept away to be employed in operations of Murabaha and in case the buyer changes his mind and asks to stop the purchase.

Provisions for operational loss of value: it's an amount that is dedicated to cover the increase of the assets value of the Murabaha's operation.

Open investment account: the account owner gives the right to the bank to invest his money, based on Mudaraba operations that it finds suitable, without obliging it to invest, either in a define project, or in a special product, or in a certain way. The client, allows the bank to mix his money with its funds sharing the profit distributes by the bank remunerating these accounts.

Restricted investment account: the account owner gives the right to the bank to invest his money, on base of Mudaraba contract or agent of investment contract and he restricts the bank on some conditions.

Article 2: this decision applies on all Murabaha operations ordered by the client where these operations are accompanied with an irrevocable promise of purchase, regardless of where the Islamic bank acquires the property of the asset from his own funds or for funds that he is commissioned to use.

Article 3: the Islamic bank should apply the rule of obliging the client to buy in the Murabaha's operation, and not hence to enter in Murabaha where the client doesn't commit to purchase the Asset after complying with its specification

Article 4: the Murabaha's contract should contain, in an explicitly clear way, the following:
1- Rights and commitments of the parties, proving that it's an operation of Murabaha for the order given to buy.
2- The asset being the subject of the contract
3- A determination of the expected cost, stamps and duties, incurred by the order given and the order taker, specially the agreed upon profit or mark up.
4- To indicate all the guaranties given by the order given

5- To indicate the deposit prepaid by the order given, providing it is in cash, and not less than 15% of the general amount that the bank expects to pay
6- To indicate the payment method and the penalties incurred in case in case of eventual delay in payments.

Article 5: Murabaha accounting operations should respect the annex attached to this resolution.

Article 6: Islamic bank are not allowed to possess assets from unexecuted Murabaha for more than six months from the possession date. The Central Council has the right to enforce on the Islamic bank to adopt all decision he finds imperative to liquidate the above noticed.

Article 7: In addition to the regulations of this decision, all the rules and regulations concerning non-Islamic bank should be applied on the Islamic bank, except the text that are opposed in Islamic bank

Article 8: This Decision shall be effective upon its issuance.

Article 9: This Decision shall be published in the Official Gazette.

Beirut, October 20, 2004
The Governor of the Banque du Liban
Riad Toufic Salamé

Accounting treatment of Murabaha operation

1-Promise of purchase (first contract in Murabaha operation)
The contract is registered with its name value in the liabilities of the extra balance sheet, then the value is provisioned when the promise is executed (second contract of Murabaha's operation), or when the promise in sot executed so that the same amount is registered in other accounts in the extra balance sheet.

2- Available funds for operation
a- Available funds for Murabaha: those funds are registered with the date of the contract of purchase decision in the balance sheet and extra balance sheet according to the percentage of financing, majored with all the costs incurred, that the bank assumes in order to own, acquire or receive the assets. Later, this cost will be diminished according to any changes and this, before pursuing the promise of purchase. These changes affect the order receiver and/or investors open account according to the percentage of contribution.
b- Available funds from unexecuted Murabaha's operation

Those assets are reclassified with other assets of unexecuted Murabaha according to their Book Value. This value is reevaluated if any changes occur and are affected to the value of downpayment deposited. However, the change occurring from the difference between the market price and the cost is registered in Provisions for operation loss value

3-Provisions for operation loss of value

This provision is instored in case of decrease of the market price compared to the cost. In case of a subsequent increase of the market cost, this provision should be restored. The value of the asset will be reevaluated and booked accordingly, when the monthly Financial Reports are prepared.

4-Deposit/down payment

a- The cash deposit is booked in the liabilities….

b- At the execution of the second Murabaha's contract, the deposit registered in the liabilities is transferred in the future sales account of the Murabaha's operations

c- When the Available funds from unexecuted Murabaha's operation are liquidated, the deposit supports the loss, and the sold is returned to the client, or any deficit will be booked under Financial Liabilities.

5- Deferred liabilities of the sales operation of Murabaha

a- At the execution of the promise of purchase, the value of the second contract is booked on the client's account in the differed sales liabilities of Murabaha in the balance sheet and extra balance sheet according to the percentage of contribution. The offered guaranties are booked in the extra balance sheet under physical guaranties and are liberated when the contract is executed.

b- In case the client ceases to pay, his account will be classified under doubtful sales deferred receivables in the balance sheet and extra balance sheet, according to the contribution. A provision should be instored equivalent to the doubtful amount

6- Deferred profits

a- At the execution of the promise of deferred purchase, the operation's profit are booked in the account of differed profits, in the differed booking of the operation of sales of Murabaha and it's considered as revenues for the bank and/or for the investors according to the level of investment , based on the maturities in a periodic manner.

b- After classifying the client's account into doubtful receivables, the deferred profits are classified accordingly, and will be considered, after recovery of each installment the bank and/or for the investors according to the level of contribution.

7- Acquired discount after purchase/post sale extended discount

a- Acquired discount after purchase, is admitted, after the bank buys the asset and before it sell it to the client reducing its price. But, if the discount has occurred after the sale it considered as per the advice of the Sharia Board.

b- When the bank extends to the client a discount for an installment or several installments pre-payment, the client's deferred sales receivables account is reduced by this amount, against reducing the account of the deferred profits, if not yet considered as revenues. In that case the

revenues of the bank is reduced and/or the revenues of the depositors according to the level of contribution.

8- Open investment account/ restricted investment account

- The open investment account is booked in the balance sheet
- The restricted investment account is booked extra balance sheet

BANQUE DU LIBAN
Basic Circular No. 97 addressed to Banks

Attached is a copy of Basic Decision Nº 8954 of January 19, 2005 relating to participating operations (Musharaka) carried out by Islamic banks.

Beirut, January 19, 2005
The Governor of the Banque du Liban
Riad Toufic Salamé

Banque du Liban
Basic Decision No. 8954
Musharaka instrument regulation carried out by Islamic banks

The Governor of the Banque du Liban,

Pursuant to the Law of currency and credit notably article 70 thereof,
Pursuant to Law Nº 575 of February 11, 2004, relating to the establishment of Islamic Banks in Lebanon, notably Article 4 thereof;
And Pursuant to the Decision of the Central Council of the Banque du Liban taken in its meeting of January 12, 2005,
Decides the following:

Article 1: For the purpose of applying the provisions of this Decision, the following expressions shall mean:

Equity Participation or Musharaka: The bank or the agent offers money to create a new project or to participate in an existing one, in order to share the resulting profits, so that everyone will own a share proportional to his contribution.
The participation can be either fixed or digressive within the applied legal framework.

Fixed Musharaka: it's the Musharaka where the share of participant remains in the project capital for the period of time specified in the contract.
The participation leading to acquisition The Musharaka mountahia bi tamlik: the bank gives the right to one partner of the partners to buy progressively the shares of the bank. So the shares of the bank will diminish and the share of the participants will increase, until the partners will be the sole owners of the project.
Contributions: is a Musharaka where the bank acquires stocks or fixed Assets or rights representing an ownership in the capital of an establishment.

Article 2: Islamic banks are prohibited to participate, directly or indirectly, in any investment for its own account except by using its own capital or its deposits conformant to the article 307 of the code of commerce where the owners confirm their acceptance by writing.

Article 3: The Musharaka contract must explicitly and accurately include, at least, the following:
1-Purpose of Musharaka
2- Size, form, and percentage of the capital that is invested
3-Period of participation
4- Rights and obligations of the parties, especially in order to allow for the bank to follow Musharaka work if the agent is appointed as sole manager
5-Process of profit and loss distribution, that has to be a percentage and not a fixed amount, So that the distribution of the loss is proportional to the contribution capital of each. This condition is mandatory and un-opposable
6- The guarantees given by the agent that hedges the effects of mismanagement of the participation.
7- Rules and conditions of the dissolution of the Musharaka and the distribution of the assets

Article 4: the Musharaka contract cannot contain any text that gives the right for any of the parties to withdraw their contribution from the capital. But it should stipulate the conditions of progressive withdrawal in case of revolving Musharaka, in a contract that is different than the one of the basic Musharaka.

Article 5: Islamic bank shouldn't possess assets from operations of liquidating participation for more than six months from the possession date. And the Central Council asks from the Islamic bank to respect all decision he finds imperative to liquidate the assets that we've already noticed.
Article 6: In addition to the regulations of this decision, all the rules and regulations concerning non-Islamic bank should be applied on the Islamic bank, except the text that are opposed in Islamic bank.
Article 7: This Decision shall be effective upon its issuance.
Article 8: This Decision shall be published in the Official Gazette.

Beirut, January19, 2005
The Governor of the Banque du Liban
Riad Toufic Salamé

BANQUE DU LIBAN
Basic Circular No 98 addressed to Banks

Attached is a copy of Basic Decision No. 9041 of June 1, 2005, on Islamic Collective Investment Schemes.

Beirut, June 1, 2005
The Governor of the Banque du Liban
Riad Toufic Salamé

BANQUE DU LIBAN
Basic Decision No 9041: Islamic Collective Investment Schemes

The Governor of the Banque du Liban,

Pursuant to Law No 575 of February 11, 2004 relating to the Establishment of Islamic Banks in Lebanon, notably Article 4 thereof; Pursuant to Law No 520 of June 6, 1996 relating to the Development of Financial Markets and Fiduciary Contracts, notably Article 1 thereof; and pursuant to the Decision of the Central Council of the Banque du Liban, taken in its meeting of May 31, 2005,

Decides the following:

Article 1: For the purpose of applying the provisions of this Decision, the following expressions shall mean:
Scheme: An Islamic collective investment scheme in Islamic financing operations and other financial instruments, whether specialized or not in a specific project (or projects) and which object is restricted to the collective investment of the funds received from the investors according to the risks distribution principle and the principles and provisions of Islamic Law (Sharia) that are not in conflict with the provisions of mandatory legal and regulatory texts in force. _An Islamic collective investment scheme may be established as a collective investment fund or as an open-ended collective investment company.
Fund: The collective investment fund specialized in investing, according to the provisions of Islamic Law, in Islamic financing operations and other financial instruments.
Company: The Lebanese joint-stock open-ended company specialized in investing, according to the provisions of Islamic Law, in Islamic financing operations and other financial instruments.
Manager: The Islamic bank operating in Lebanon entrusted with the management of the Fund or the Company, by virtue of management contract.
Investments:
a- Investment of funds in order to acquire stocks, Islamic sukuk or collective investment scheme units for the purpose of receiving a return. The investments encompass as well all assets purchased in order to be developed for sale or lease.

b- Purchase and sale of stocks for trading.

Bouyouh (sales): Trading operations carried out through any Islamic device (as in Murabaha, or Salam…).
Specialized Islamic Collective Investment Schemes: Schemes that invest directly in a specific object-defined project(s) proposed to the investors by the Scheme Manager, with the Scheme term being limited to the duration of the project(s).
Units: The nominal stocks, shares or sukuk representing their holders' ownership in the Scheme assets.
Net Assets: Represents the investors' rights and comprises the contervalue of the contributions of Units holders, the undistributed net investments income (or investments losses), the undistributed net realized profits (or net realized losses), the net increase or decrease in the investments value and any other assets.
Capital contributions: The additional funds collected from unit holders or third parties, without issuing Units in exchange, for the purpose of financing the Scheme or strengthening its credit status.

Article 2: Institutions other than Islamic banks operating in Lebanon are prohibited from managing Islamic collective investment schemes operating in Lebanon.

Article 3: The management contract signed between the Manager and the Company management body must explicitly and accurately include, at least, the following:
1- The Manager's rights and obligations, particularly the explicit statement that the Manager has the exclusive right to run the Company's operations.
2- The duration of the contract.
3- The cases in which the contract may be amended, ended, or terminated.

Article 4: Upon the establishment and the starting up of specialized collective investment schemes, the Manager shall:
1-Prepare a comprehensive feasibility study on the project(s) being the object of the Specialized Scheme, indicating its expected duration and potential risks, and including all information regarding the financial and credit status of the parties to be financed, so as to show their ability to meet their obligations, in such a way as to guarantee the stockholders the utmost accuracy and transparency.
2- Provide the investors wishing to subscribe to the mentioned Scheme with a copy of the entire afore-mentioned feasibility study in addition to the prospectus; and obtain from the investors duly signed subscription documents ascertaining that they have been fully informed of the project(s) feasibility study and related risks, that they have accepted them as well as the prospectus and By-Laws terms of this Scheme and that they are fully responsible for the investment results, due account being taken of their right to have recourse to the Manager in case of negligence or abuse. Moreover, the aforementioned subscription documents must include an absolute power of attorney given by the investors to the Manager for running the project(s) according to the agreed conditions.

3- Keep all papers and documents proving the ownership of the project(s) or the related rights or relevant guarantees. Such papers and documents must be in the name of the Scheme or, if need be, in the name of the Manager in his proxy capacity on behalf of the investors.
4- Inform the investors periodically, as specified in the subscription notice, of the results of the investment, of any risks or problems that have arisen and of the remedial measures that have been taken.

Article 5: The Manager must appoint a Sharia regulatory body or a Sharia consultant, entrusted with the setting of the Sharia-based rules governing the management of the Scheme investments and which should not be inconsistent with the provisions of the laws and regulations in force.

Article 6: In addition to any other information required by virtue of the regulations and decisions governing the activities of collective investment schemes, the prospectus must include, in particular, the following information:
1- The type of the Scheme, its main activity, the significant investment policies governing its activity, the objectives of its investments, and an explicit mention that the Scheme has been established according to the provisions of the Islamic Law (Sharia).
2- The adopted accounting policy for evaluating the investments, receivables, financing operations and other assets.
3- The accounting policy to be adopted for proving the income.
4- The accounting policy to be adopted for amortizing the establishment costs of the Scheme.
5- The rules governing the investor's redemption of his units in whole or in part.
6- The contractual relationship between the Scheme and the party (or parties) it manages, when necessary.
7- The rules governing the Scheme sale of assets belonging to the Manager or in which he has interest.
8- The rules governing the operations undertaken jointly by the Manager and the Scheme in the financing of all or part of the Scheme operations.
9- The rules governing the investment operations that the Manager can undertake in the Scheme he manages.
10- The commission that can be paid to the Manager and which must exclusively be either a lump sum or a percentage of the Scheme profits or a percentage of contributions value or a percentage of the Scheme net assets value.
11- The rules governing the Scheme investment operations in another Scheme managed by the Manager.
12- The rules for the evaluation of the Scheme assets and the contributions in kind, if any.
13- The procedures to be followed in case of non Sharia compliant profit.
14- To indicate the party responsible for withholding the Zakat (mandatory alms), whether the unit holders or the Scheme. In case the latter is responsible, it must disclose the Zakat due for each unit.
15- To indicate whether the Scheme will constitute provisions to meet any obligations.
16- The duration of the Scheme and the conditions of its liquidation.

Article 7: The Manager must:
1-Prepare the financial statements of the Scheme, according to Forms 1, 2, 3, 4 and 5 attached to this Decision.
2-Provide the Banque du Liban (Financial Markets Department and Legal Department), before the end of April, with the afore-mentioned statements.

Article 8: At least 50% (fifty per cent) of the Scheme assets must be represented by investments or placements in Lebanon.

Article 9: In addition to the provisions of this Decision, Islamic collective investment schemes shall be governed, unless otherwise provided for, by all the provisions, regulations and principles relating to:
1- The collective investment schemes.
2-The Islamic banking operations that are the object of the Scheme.

Article 10: This Decision shall be effective upon its issuing.

Article 11: This Decision shall be published in the Official Gazette.

Beirut, June 1, 2005

BANQUE DU LIBAN
Basic Circular No. 99 addressed to Banks

Attached is a copy of Basic Decision Nº 9042 of June 1, 2005 relating to the Ijara Tachghilia and the Ijara Mountahia bil Tamalouk operations carried out by Islamic banks.
Beirut, June 1, 2005
The Governor of the Banque du Liban
Riad Toufic Salamé

Banque du Liban
Basic Decision No. 9042

The Ijara Tachghilia and the Ijara Mountahia bil Tamalouk operations carried out by Islamic banks

The Governor of the Banque du Liban,
Pursuant to Law Nº 575 of February 11, 2004, relating to the establishment of Islamic Banks in Lebanon, notably Article 4 thereof; and
Pursuant to the Decision of the Central Council of the Banque du Liban taken in its meeting of May 31, 2005,
Decides the following:

Article 1: The Ijara Tachghilia and the Ijara Mountahia bil Tamalouk operations carried out by Islamic banks shall be governed by the provisions of this Decision.

Article 2: The lease is an Ijara Tachghilia when it does not end with the acquisition of the leased assets by the lessee. The lease is an Ijara Mountahia bil Tamalouk when it provides for the lease's option to acquire the leased asset.

Article 3: The following leasing operations shall not be governed by the provisions of this Decision:
1- Leasing contracts regarding exploration rights and the use of natural resources, such as oil, gas, wood forests, minerals and the like.
2- Licensing contracts for the exploitation of intangible movable assets such as patents copyrights, etc….
3- Employment and professional services contracts.

Article 4: The lease agreement signed by the bank in its capacity of lessor, must at least expressly and accurately include the following elements:
- The type of lease (Ijara Tachghilia or Ijara Mountahia bil Tamalouk).
- The leased asset and its modality of use.
- The lessee's option to acquire the leased asset in case of an Ijara Mountahia Bil Tamalouk.

- The rent and its payment modalities.
- The lease duration.
- The maintenance expenses.
- The guarantees required from the lessee and their recovery modalities.
- The events of rescission, termination and renewal of the lease.
- The mandatory insurance on the leased asset to be made to the benefit of the bank.

Article 5: The Islamic banks must liquidate their owned-for-lease assets that have not been leased within six months from their acquisition date. They must also lease again or liquidate the assets covered by both types of lease operations, either within six months from the contract term date in the event the lessee did not opt for their acquisition, or from the date the contract is terminated before its term for any reason. In the event the Islamic bank is unable to comply with the abovementioned time-limits for reasons beyond its control it must refer to the Banque du Liban.

Article 6: The Islamic banks are prohibited from carrying out both types of lease operations and act as a lessor of real estate properties before obtaining the Banque du Liban prior approval. This approval is contingent upon the concerned bank's compliance with the laws and regulations in force, notably as to its compliance with the mandatory ratios on its investments in fixed assets.

Article 7: This Decision shall be effective upon its issuance.
Article 8: This Decision shall be published in the Official Gazette.

Beirut, June 1, 2005
The Governor of the Banque du Liban
Riad Toufic Salamé

BANQUE DU LIBAN
Circulaire de base No 100 adressée aux banques

Veuillez trouver ci-joint une copie de la Décision de base No 9084 du 16 juillet 2005, relative aux opérations de Mudaraba effectuées par les banques islamiques.

Beyrouth, le 16 juillet 2005
Le Gouverneur de la Banque du Liban
Riad Toufic Salamé

BANQUE DU LIBAN
Décision de Base No 9084
Opérations de Mudaraba effectuées par les banques islamiques
Le Gouverneur de la Banque du Liban,
Vu les dispositions du Code de la Monnaie et du Crédit, notamment celles de l'Article 70, Vu les dispositions de la loi No 575 du 11 février 2004, relative à l'Etablissement des Banques Islamiques au Liban, en particulier celles de l'Article 4 ; et Vu la Décision adoptée par le Conseil Central de la Banque du Liban en sa séance du 13 juillet 2005,
Décide ce qui suit :

Définitions :
Pour les besoins d'application de cette Décision, les expressions suivantes signifient:

Opérations de Mudaraba : Opérations conclues entre la banque en tant que pourvoyeur de « capital » et l'agent « moudarib » en tant qu'investisseur dudit « capital ».
Détenteur de capital : La banque islamique qui détient le « capital ».
Capital : La somme prélevée sur les fonds propres de la banque et/ou des comptes d'investissement absolu ou conditionné.
Moudarib : L'agent du « détenteur de capital » investissant dans le « capital » conformément aux clauses du contrat signé avec lui, ainsi qu'aux dispositions des lois et règlements en vigueur.

Article 1 : Cette Décision s'applique aux opérations de financement en Mudaraba effectuées par la banque islamique en sa qualité de « Détenteur de capital », que le « capital » de Mudaraba soit prélevé sur les fonds propres de la banque ou sur la part des fonds propres ajoutée aux comptes d'investissement absolu, ou sur les comptes d'investissement absolu ou conditionné.

Article 2 : Le contrat de Mudaraba doit au moins comprendre, de manière claire et précise, les éléments suivants:
1-Le montant du « capital » de Mudaraba, en espèces ou en nature, ainsi que les charges qui y sont incluses.
2-La durée de la Mudaraba.

3-Les droits et obligations des parties, particulièrement la possibilité donnée au « Détenteur de capital » de contrôler et vérifier les comptes de la Mudaraba, ainsi que les documents y afférant tenus par le « Moudarib ».
4-Les garanties fournies par le « Moudarib » contre tout manquement, négligence ou violation de sa part des clauses du contrat de Mudaraba.
5-Les conditions et les règles relatives à la prolongation, la liquidation ou le partage de la Mudaraba.
6-Le mode de distribution des bénéfices de la Mudaraba, qui doit prendre la forme d'un pourcentage indivis des bénéfices et non d'une somme forfaitaire ou d'un pourcentage du « capital » de la Mudaraba.
7-La date et les modalités de remise du « capital » de la Mudaraba au « Moudarib » ou de la mise dudit capital à la disposition de ce dernier.
8-Une déclaration par laquelle le « détenteur de capital » précise qu'il accepte que le Moudarib emprunte sur le « capital » de la Mudaraba ou le prête ou le transfère à un tiers sous forme de Mudaraba, en indiquant les conditions régissant ces opérations.
Article 3 : Le « Détenteur de capital » doit, si nécessaire, ouvrir au nom du « Moudarib » un compte sur lequel les retraits peuvent être réalisés, et dans lequel le « capital » et les revenus de la Mudaraba peuvent être déposés.

Article 4 : Le « Détenteur de capital » doit assumer toute perte découlant de l'opération de Mudaraba, lorsqu'elle ne résulte pas du manquement, de la négligence, ou de la violation des conditions de la Mudaraba par le Moudarib.

Article 5 : Le « Détenteur de capital » ne peut détenir, pour une période dépassant six mois, des actifs provenant de la liquidation ou du partage des opérations de Mudaraba. Il revient au Conseil Central d'obliger le « Détenteur de capital » à se conformer à toute mesure qu'il juge nécessaire pour la liquidation des actifs susmentionnés.

Article 6 : Le « capital » de la Mudaraba ne peut pas constituer une créance du « Détenteur de capital » sur le « Moudarib » ou sur une autre partie.

Article 7 : En sus des dispositions de la présente Décision et sauf stipulation contraire, les banques
Islamiques sont régies par toutes les dispositions et réglementations relatives aux banques non Islamiques.

Article 8 : Cette Décision entrera en vigueur dès sa promulgation.
Article 9: Cette Décision sera publiée au Journal Officiel.

Beyrouth, le 16 juillet 2005
Le Gouverneur de la Banque du Liban
Riad Toufic Salamé

Circulaire de base No. 101 adressée aux banques

Veuillez trouver ci-joint une copie de la Décision de base No. 9207 du 10 décembre 2005, relative aux opérations de « Bai Al Salam » des banques islamiques au Liban.
Beyrouth, le 10 décembre 2005
Le Gouverneur de la Banque du Liban
Riad Toufic Salamé

Banque du Liban
Décision de base No. 9207

Relative aux opérations de « Bai Al Salam » des banques islamiques au Liban

Le Gouverneur de la Banque du Liban,
Vu les dispositions du Code de la Monnaie et du Crédit,
Vu les dispositions de la loi 575 du 11 Février 2004, relative à l'établissement des banques islamiques au Liban, notamment celles des articles 3 et 4,
Vu la Décision adoptée par le Conseil Central de la Banque du Liban en sa séance du 7 décembre 2005,
Décide ce qui suit :

Article 1: **Définitions**
Pour les besoins d'application de cette Décision, les expressions suivantes signifient:
Bai Al Salam : c'est un contrat par lequel, la banque fait une avance d'un certain montant d'argent au vendeur. En contrepartie, ce dernier se doit de lui livrer une quantité de biens meubles, à une date fixée au préalable par les deux partis.
Al Mousallam fih: les biens meubles de la vente.
Al Mousallam ilayhi: le vendeur.
Al Mousallam: la Banque Islamique qui achète à « Al Mousallam fih ».

Article 2: Les ventes de Salam sont soumises aux lois et règlements en vigueur, et notamment l'article 487 et ce qui suit du code des obligations et des contrats.

Article 3: le contrat de Bai Al Salam, doit absolument contenir, et de manière claire et précise, les clauses suivantes :

1- Les droits et devoirs des deux partis, de façon à prouver que l'opération est une opération de « Bai Al Salam ».
2- Al Mousallam fih, l'objet du contrat (sa nature, sa qualité, ses caractéristiques, sa valeur,…)
3- Précision du coût, des dépenses, des taxes, des frais, tous les montants payés par la Banque Islamique, ainsi que la date de paiement.
4- Précision toutes les garanties présentées par le vendeur.

5- Précision la date et la procédure de livraison de la part du vendeur à la Banque Islamique, ainsi que les mesures à prendre en cas de non-livraison à la date fixée.

Article 4: Au moment de la création du contrat de « Bai Al Salam », les dettes du vendeur avec l'acquéreur (Banque Islamique) ne peuvent pas être affectées, réduites, échangées, ou consolidées avec le bien meuble sujet de la vente.

Article 5: La banque Islamique ne doit disposer, pendant une période dépassant les six mois, des actifs résultant des opérations de « Bai Al Salam ». C'est au conseil Central de renouveler ce délai ou d'obliger la banque à se conformer à des règlements qu'il juge nécessaires afin de liquider les actifs ci-dessus.

Article 6: En sus des dispositions de la présente décision, et sauf stipulation contraire, les banques Islamiques sont régies par toutes les dispositions et réglementations relatives aux banques non islamiques.

Article 7 : Cette Décision entrera en vigueur dès sa promulgation.

Article 8: Cette Décision sera publiée au Journal Officiel.

Beyrouth, le 10 décembre 2005
Le Gouverneur de la Banque du Liban
Riad Toufic Salamé

Circulaire de base No. 102 adressée aux banques

Veuillez trouver ci-joint une copie de la Décision de base No. 9208 du 10 décembre 2005, relative aux opérations de Istisna'a des banques islamiques au Liban.
Beyrouth, le 10 décembre 2005
Le Gouverneur de la Banque du Liban
Riad Toufic Salamé

Banque du Liban
Décision de base No. 9208

Relative aux opérations de Istisna'a des banques islamiques au Liban

Le Gouverneur de la Banque du Liban,
Vu les dispositions du Code de la Monnaie et du Crédit,
Vu les dispositions de la loi 575 du 11 Février 2004, relative à l'établissement des banques islamiques au Liban, notamment celles des articles 3 et 4,
Vu la Décision adoptée par le Conseil Central de la Banque du Liban en sa séance du 7 décembre 2005,
Décide ce qui suit :

Article 1: **Définitions**
Pour les besoins d'application de cette Décision, les expressions suivantes signifient:
Al Sani' (le vendeur) : l'agent de la banque islamique.
Al Moustasni' (l'acheteur) : La banque Islamique.
Contrat de « Istisna'a » : c'est un contrat de vente entre Al Moustasni' et Al Sani'. Ce dernier, suite à la demande du Moustasni', produit de la marchandise bien définie ou la reçoit au moment de la livraison, et ce en contrepartie d'un montant fixé par les deux partis.

Article 2: Les opérations de Istisna'a sont considérées, selon cette décision, comme des opérations de production où la matière offerte par le Sani' est l'objet principal dans le contrat, et le travail présenté, secondaire.

Article 3: Le contrat de Istisna'a, doit absolument contenir, et de manière claire et précise, les clauses suivantes :

6- Les droits et devoirs des deux partis, de façon à prouver que l'opération est une opération de « Istisna'a » conformément à cette décision.
7- Description clairement la marchandise (sa nature, sa qualité, ses caractéristiques, sa valeur,…), objet du « contrat de Istisna'a ».
8- Précision le coût de la marchandise, son mode de paiement, ainsi que les dépenses, les coûts, les frais et les taxes payés par Al Moustasni'.
9- Précision de toutes les garanties présentées par Al Sani'.
10- Précision de la date et de la procédure du Sani' pour la livraison de la marchandise, objet du « contrat de Istisna'a », ainsi que les pénalités en cas de retard de livraison.

11- Si il y a possibilité de la part du Sani' de compenser la marchandise, objet du « contrat de Istisna'a ».

Article 4: Au moment de la création du contrat de « Istisna'a», les dettes du Sani' avec le Moustasni (Banque Islamique) ne peuvent pas être affectées, réduites, échangées, ou consolidées avec le bien meuble sujet de la vente.

Article 5 : Il est interdit au Moustasni' d'accepter ou de financer des contrat de Istisna'a déjà crées.

Article 6 : Il est interdit au Moustasni' d'entrer en son propre compte dans contrats de Istisna'a avec de sociétés de sa propriété, directement ou indirectement, dans une proportion d'un tiers ou plus.

Article 7 : Il est interdit au Moustasni' de faire un contrat de Murabaha avec le même Al Sani', et concernant la même marchandise, objet du « contrat de Istisna'a ».

Article 8 : La banque Islamique ne doit disposer, pendant une période dépassant les six mois, des actifs résultant des opérations de « Istisna'a ». C'est au conseil Central de renouveler ce délai ou d'obliger la banque à se conformer à des règlements qu'il juge nécessaires afin de liquider les actifs ci-dessus.

Article 9 : Les opérations de Istisna'a sont soumises aux lois et règlements en vigueur, notamment, le second paragraphe de l'article 658 et l'article 372, et ce qui suit comme du code des obligations et des contrats.

Article 10: En sus des dispositions de la présente décision, et sauf stipulation contraire, les banques Islamiques sont régies par toutes les dispositions et réglementations relatives aux banques non islamiques.

Article 11 : Cette Décision entrera en vigueur dès sa promulgation.

Article 12: Cette Décision sera publiée au Journal Officiel.

Beyrouth, le 10 décembre 2005
Le Gouverneur de la Banque du Liban
Riad Toufic Salamé

Appendix C

List of interviews

Name	Institution	Title	Date	Subject
H.E. Dr Ahmed Jachi	**BDL**	*Vice Governor*	*06/04/2006*	Lebanon as an Islamic Financial Hub
H.E. Mr. Yacoub Sarraf		*Minister of environment*	*22/04/2006*	Investment projects for a better environment in Lebanon
H.E. Dr. Elias Saba		*Former Finance Minister*	*17/04/2006*	Effect on Lebanon GDP of Islamic banking
Abdul Ghani Datuk Zamani	**Bank Negara Malaysia**	*Deputy governor*	*18/05/2006*	5 year Malaysian plan for Islamic banks
Dr Francois Bassil	**Byblos Bank**	*Chairman*	*05/05/2006*	Client acceptance of Islamic Finance products in Lebanon
Mr. Salah Jaidah	**Qatar Islamic Bank**	*CEO*	*19/05/2006*	Perspective of investments in Lebanon
H.E. Mr. Adnan Kassar	**Fransabank**	*CEO*	*10/05/2006*	Perspective of Fransabank in the Islamic financial market
Dr Jamil Jaroudi	**Arab finance house**	*DGM*	*06/04/2006*	Islamic Finance Industry in Lebanon
Mr. Khaled Temsah	**Lebanese Islamic Bank**	*CEO*	*28/04/2006*	Comments on the laws and regulations of Islamic Banking in Lebanon
Mr. Mohammed Al-Omar	**Kuwait Finance House**	*Deputy G.M.*	*19/05/2006*	Is Lebanon an attractive plaza for KFH
Mr. Saad Jamaleddine	**Arab Finance House**	*Senior executive manager*	*02/05/2006*	Islamic Finance instruments in Lebanon
Mr. Bernard Barbour	**BDL**	*Legal department*	*18/04/2006*	Legal aspects of the regulations
Sheikh Dr Khaled Faqih	**Arab finance house**		*19/04/2006*	Sharia Board in Lebanon
Mr. Sidiqi el Zein	**Qatar Islamic Bank**	*Communication officer*	*18/05/2006*	Marketing and communication approach
Rohana Yusuf	**High Court, Malaysia**	*Judicial commissioner*	*18/05/2006*	Legal framework of disputes and arbitrage in Islamic Contracts
Dr Fadi Gemayel	**Ministry of Industry**	*Consultant*	*18/04/2006*	Need of a social financial approach for SME
Dr Joe Sarrou	**Fransabank**	*Investment banking*	*10/05/2006*	feasibility of an Islamic Bank in Lebanon
Mr. Nabil Chaya	**Audi Saradar bank**	*Capital market*	*20/04/2006*	Islamic capital markets in Lebanon
Mr. Walid Abdulla Rashdan	**Kuwait Finance House**	*Executive manager*	*19/05/2006*	The attributes of the Lebanese market for establishing an Islamic bank
Mr. Iyad	**Bsec-BEMO**	*G.M.*	*01/06/2006*	Islamic securitization: practical

Boustany				aspects
Mr. Nassib Ghobril	**Byblos Bank**	*Head of research*	*03/05/2006*	The banking sector of Lebanon. Facts and data
Mr. Talal Kaisi	**Al Baraka bank lebanon**	*Branches manager*	*05/06/2006*	Instruments and products offered to bank's clients
Sheikh Bilal alMulla	**Al Baraka bank lebanon**	*Sharia Internal controller*	*05/06/2006*	The Sharia board modus operandi
Mr. Anouar Hassoune	**Standard and Poors-France**	*Director*	*19/05/2006*	Islamic Finance in Europe
Prof. Simon Archer	**University of Surrey**		*18/05/2006*	AAOFI standards for Islamic Banks balance sheets
Mr. Hiro Tsubota	**The world bank**	*Regional financial officer*	*18/05/2006*	Sukuk and fixed income projections in Islamic Finance
Mr. Ahmed Barghout	**Al Multaqa**	*Founder*	*19/04/2006*	Islamic Finance growth in the GCC markets
Miss Lina Tayyara	**Kroll international**	*Risk manager*	*24/04/2006*	Risk management in Islamic finance

Table 5-1 List of Interviews conducted by the author.

Appendix D

List of Islamic Financial institutions, by country, as of 2003

Islamic financial institutions by country

Country	*Islamic financial institution*
Albania	Arab Albanian Islamic Bank, Tirana
Algeria	Banque Albaraka D'Algérie, Algeries
Australia	MCCU (Muslim Community Credit Union
Bahamas	Akida Islamic Bank Internatioanl Ltd
	Bank Al Taqwa Ltd
	Dar al Mal al Islami Trust, Nassau
	Islamic Investment Company of the Golf ltd, Nassau
	Istishara Consulting Trust, Bahamas
	Massraf Faysal Islamic Bank& Trust, Bahamas Ltd.
Bahrain	ABC Islamic Bank
	Al Amin Co. for securities and Investment Funds
	Albaraka Islamic Investment Bank
	Bahrain Islamic Bank Bsc.
	Bahrain Islamic Investment Co. Bsc. Closed
	Citi Islamic Investment Bank (Citicorp)
	Dallah AlBaraka (Europe) Ltd
	Faysal Investment Bank of Bahrain
	First Islamic Investment Bank

	Gulf Finance House
	Investors Bank
	Islamic Trading Company
	Khaleej Investment Company
	Shamil Bank
	Takaful International Co. BSC
Bangladesh	Albaraka Bangladesh Ltd (Dallah Al Baraka Group), Dhaka
	Faisal Islamic Bank
	Islami Bank Bangladesh Ltd, Dhaka
British Virgin Island	Ibn Khaldoun International Equity Fund Ltd
Brunei	Islamic Bank of Brunei Berhad
	Islamic Development Bank of Brunei Berhad
	Tabung Amanh Islam Brunei
Canada	Al Tawfeek Co. For Investment Funds Ltd. Subsidiary of Albaraka Group "DGB"
	Ibn Majid Emerging Marketing Fund (International Investor Group)
	Islamic Co-operative Housing Corporation Ltd. Toronto
Denmark	Faisal Finance (Denmark) A/S
Djibouti	Banque Albaraka Djibouti
Egypt	Faisal Islamic Bank of Egypt, Cairo
	Islamic Bank International for investment and development, Cairo
	Islamic Investment and Development Co., Cairo
Gambia	Arab Gambian Islamic Bank

Guinea	Banque Islamique de Guinee
	Massraf Faisal al Islami of Guinea, Conakry
India	Al Ameen Islamic Financial & Investment Corp. (India) Ltd., Karnatka
	Al- Falah Investment Ltd.
Indonesia	Al Barakah Islamic Investment Bank
	Bank Muamalat Indonesia, Jakarta
	Dar Al-Mal Al-Islami Trust
	PT Danareksa Fund Management, Jakarta
Iran	Bank Keshavarzi (Agriculture Bank), Tehran
	Bank Maskan Iran (Housing Bank), Tehran
	Bank Mellat, Tehran
	Bank Melli Iran, Tehran
	Bank Saderat Iran, Tehran
	Bank Sanat Va Maadan (Bank of Industry and Mines), Tehran
	Bank Sepah, Tehran
	Bank Tejarat, Tehran
Iraq	Iraqi Investment bank for Investment and Development
Ireland	Al Meezan Commodity Fund Plc, Dublin
	The Islamic Investment Company, St Helier
Jordan	Jordan Islamic Bank for Finance and Investment, Amman
	Jordan Islamic Insurance Co.
	Arab Islamic International Bank (AIIB),Plc
Kuwait	Gulf Investment Corporation

	A’ayan Leasing and Investment Company
	Aref Investment co.
	Aviation Lease and Finance Co.Ltd. (ALAFCO)
	Kuwait Finance House, Safat
	Kuwait Investment Co-Dar Al-IsethmarSecurities House
	Osoul Leasing & Investment
	Takaful Insurance Company
	The International Investment Group
	The International Investor, Safat
	The International Leasing & Investment Company
Lebanon	Al Baraka Bank
	Arab Finance House
	Lebanese Islamic Bank
Luxembourg	Faisal Finance (Luxembourg) S.A
Malaysia	Syarikat Takaful Malaysia Berhad
	Abrar Discounts Berhad, Kuala Lumpur
	Adil Islamic Growth Fund (Innosabah Securities Sdn Bhd), Labuan
	Bank Islam Malaysia Berhad, Kuala Lumpur
	Bank Muamalat Berhad, Malaysia
	Dallah Al Baraka (Malaysia) Holding Sdn Bhd
	Takaful Nasional SDN Berhad
Mauritania	Banque Alabaraka Mauritanie Islamique (Dallah Al Baraka Group)
Morocco	Faisal Finance Maroc S.A

Niger	Banque Islamique Du Niger, Niamey
Pakistan	Al Faysal Investment Bank Ltd, Islamabad
	Al Meezan Investment Bank Limited
	Al Towfeek Investment Bank Ltd (Dallah Al Baraka Group), Lahore
	National Investment Trust Ltd., Karachi
	Shamil Bank
Palestine	Arab Islamic Bank
	The Palestine Islamic Bank
Qatar	Islamic Investment Company of the Golf Ltd, Sharja (Not in Qatar)
	Qatar International Islamic Bank
	Qatar Islamic Bank SAQ, Doha
	First Finance
Russia	BADR Bank
Saudi Arabia	Al Rajhi Banking and Investment Corp., Ryiad
	Albaraka Investment and Development Co., Jeddah
	Islamic Corporation for the Development of the Private Sector
	Islamic Development Bank
	Islamic Insurance & Reinsurance Co.
	Takaful Islamic Insurance Co. Ec
	The Islamic Corporation for the Insurance of Investment and Export Credit

	(Dallah Al Baraka Group)
South Africa	Al Baraka Bank, Ltd Durban
Senegal	Banque Islamique Du Senegal
Srilanka	Amana Islamic Bank
	Amana Investments Limited
	Amana Takaful Limited
Sudan	Al Baraka Al Sudani, Khartoum. (Dallah Al Baraka Group)
	Savings & Social Development Bank
	Al Shamal Islamic Bank
	Al Tadamon Islamic Bank, Khartoum
	Bank of Khartoum
	El Gharb Islamic Bank (Islamic Bank for western Sudan)
	Faisal Islamic Bank of Sudan, Khartoum
	Islamic Bank of Western Sudan, Khartoum
	Islamic Co-operative Development Bank, Khartoum
	Omdurman National Bank
	Shiekan Insurance & Reinsurance Co.Ltd
	Sudanese Islamic Bank
	Animal Resources Bank
	El Nilein Industrial Development Bank Group
	Farmer's Commercial Bank
	Sudanese French Bank
	The Agriculture bank of Sudan

	The Sudanese Estate Bank
Switzerland	Dar Al Maal Al Islami Trust, Geneva
	Faisal Finance (Switzerland) SA,Geneva
	Pan Islamic Consultancy Services Istishara SA, Geneva
The Netherlands	Faisal Finance (Netherlands) B.V
	Faisal Finance (Netherlands Antilles) N.V
Tunisia	B.E.S.T Re-Insurance (Dallah Al Baraka Group)
	Beit Ettamwil Al Tunisi al Saudi, Tunis (Dallah Al Baraka Group)
Turkey	Albarakah Turish Finance House Istanbul
	Faisal Finance Institution, Istanbul
	Kuwait-Turkey Evkaf Finance House
	Faisal Islamic Bank of Kibris Ltd. Turkey
	Ihlas Finance House
United Arab Emirates	ABCIB Islamic Asset Management, Arab Banking Corp
	Abu Dhabi Islamic Bank
	Dubai Islamic Bank
	HSBC Amanah Finance
	Islamic Investment Company of the Gulf Ltd, Abu Dhabi
	Islamic Investment Company of the Gulf Ltd, Sharja Subsidiary of Dar Al Maal Islami Trust
United Kingdom (UK)	Takafol (UK) Ltd, London
	Al Rajhi Investment Corporation, London
	Islamic Investment Banking Unit (IIBU), United Bank of Kuwait, London

	The Halal Mutual Investment Company Plc
	Albaraka International Ltd, London
	Alabaraka Investment Co. Ltd, London
United States of America	Abrar Investments, Inc., Stamford CT
	Al-Baraka Bancorp Inc. Chicago
	Al-Madina Realty, Inc., Englewood NJ
	Amana Mutual Funds Trust State St Bellingham WA
	Ameen Housing Co-operative, San Francisco
	American Finance House
	Failaka Investments, Inc., Chicago IL
	Dallah Al Baraka (UK) Ltd., Chicago IL
	Dubai Islamic Bank, Dubai
	Fuloos Incorporated, Toledo OH
	Islamic Credit Union of Minnesota, (ICUM)
	MEF Money, USA
	MSI Finance Corporation, Inc., Houston TX
	Shared Equities Homes, Indianapolis IN
	Takafal USA
Yemen	Faisal Islamic Bank
	Islamic Bank of Yemen for Finance and Investment, Sana
	Saba Islamic Bank, Sana
	Yemen Islamic Bank, Sana
	Tadamon Islamic Bank

Conventional banks offering Islamic financial services including "Islamic windows"

Country	*financial institution*
Bahrain	Arab Investment Company
	Investcorp
	Gulf International Bank
	BNP Paribas- Bahrain
Egypt	Egyptian Company for Business and Trade S.A.E
	Egyptian Saudi Finance Bank (Dallah Al Baraka), Cairo
	Gulf Company for Financial Investment
France	Algerian Saudi Leasing Holding Co. (Dallah Al Baraka Group)nk
Germany	Bank Sepah, Iran
Ireland	MFAI (Jersey) Limited (formely-Massraf Faysal Al-Islami Ltd, Jersey)
Italy	Bank Sepah, Iran
Ivory Coast	International Trading Co. of Africa
Malaysia	Affin Bank Berhad
	Affin Discount Berhad
	Affin Merchant Bank Berhad
	Alliance Bank Berhad
	Alliance Finance Berhad
	Alliance Merchant Finance Berhad

Amanah Short Deposits Berhad

Arab Malaysian Merchant Bank Berhad, Kuala Lumpur

Arab- Malaysian Bank Berhad

Arab- Malaysian Finance Berhad

Arab- Malaysian Merchant Bank Berhad

Aseambankers Malaysia Berhad

Asia Commercial Finance Berhad

Bank Bumiputra Malaysia Berhad, Kuala Lumpur

Bank Kerjasama Rakyat Malaysia Berhad, Kuala Lumpur

Bank Utama (Malaysia) Berhad

BBMB Discount House Berhad

Citibank Berhad

Discount Houses:

EON Bank Berhad

EON Finance Berhad

Hong Leong Bank Berhad

Hong Leong Finance Berhad

HSBC Bank (M) Berhad

KAF Discounts Berhad

Kewanga Bersatu Berhad

Lembaga Ursuan Da Tabung Haji (Fund), Kuala Lumpur

Malaysian Banking Berhad

Malaysian Banking Berhad (Maybank), Kuala Lumpur

	Malaysian Discount Berhad
	Malaysian International Merchant Bank Berhad
	Mayban Discount Berhad
	Mayban Finance Berhad
	MBf Finance Berhad
	Multi-Purpose Bank Berhad, Kuala Lumpur
	OCBC Bank (Malaysian) Berhad
	Public Bank Berhad
	Public Finance Berhad
	RHB Bank Berhad
	Southern Bank Berhad
	Standard Chartered Bank Malaysian Berhad
	United Malaysian Banking Corp. Berhad, Kuala Lumpur
	United Merchant Finance Berhad
Nigeria	Ahmed Zakari & Co
	Habib Nigeria Bank Ltd
Saudi Arabia	Arab Leasing International Finance (ALIF) Ltd
	Bank Al Jazira
	National Commercial Bank
	Riyadh Bank
	Saudi American Bank
	Saudi British Bank
	Saudi French Bank

Switzerland	Pictet&Cie
Turkey	Asya Finans Kurumu A.S
	Emin Sigorts A.S
United Arab Emirates	Al Safa Investment Fund
	HSBC Dubai
	National Bank of Sharjah
United Kingdom	ABC International Bank, London
	ANZ International Merchant Banking, London
	Arab Bank Plc, London
	Barclays Capital
	Cedel International, London
	Citibank International Plc, London
	Dawnay Da Global Investment Ltd
	Global Islamic Finance, HSBC Investment Bank Plc
	IBJ International, London (Subsidiary of Industrial Bank of Japan)
	J.Aron & Co. (Goldman Sachs International Finance) Ltd., London
United States of America	BMI Finance & Investment, Group, New Jersey
	Chase, J.P Morgan
	Dow Jones Islamic Index Fund of the Allied Asset Advisors Funds
	HSBC, USA
	Hudson Investors Fund, Inc., Cilifton NJ
	Samad Group, Inc., Dayton OH
Yemen	Yemen National Investment Co., Sana

Appendix E

Comparative economic indicators of Lebanon and MENA region countries. MAY 31 2006

2005 est.	UAE	Qatar	Kuwait	KSA	Bahrain	Oman	Egypt	Morocco	Jordan	Lebanon
Moody's Rating	A1	A1	A2	A3	Baa1	Baa1	Ba1	Ba1	Ba2	B3
Nominal GDP USD bn	117.06	35.44	71.52	304.43	12.83	30.86	92.93	55.85	12.19	20.88
Nominal GDP PPP bn	90.72	33.65	73.47	308.89	15.67	34.56	300.44	144	27.01	31.89
Population mn	4.67	0.8	2.86	24.6	0.74	2.81	74.02	31.48	5.78	3.58
GDP per Capita USD	25,090	44,380	24,980	12,380	17,250	10,970	1,260	1,770	2,110	5,840
GDP per Capita PPP USD	19,440	42,120	25,660	12,560	21,070	12,280	4,060	4,570	4,670	8,910
Real GDP % gr.	6.7	6.7	4.8	6.5	5.9	1.9	4.5	2	5.9	0.1
Inflation %	7.1	7.2	3.8	0.6	3.2	-	4.6	2.4	3.7	2.5
Trade Balance USD MN	42,956	13,275	32,201	120,117	3,343	10,305	-9,772	-8,674	-4,455	-7,073
Net exports/GDP %	20.26	44.93	39.27	34.59	27.21	-0.78	1.2	-7.42	-18.67	-25.38
Gov't Debt/GDP%	17.5	36.7	17.6	56.7	51.5	7.5	93.6	72.3	77.7	200.7
Exchage Rate	3.67	3.64	0.29	3.75	0.38	0.39	5.78	8.78	0.71	1507.5
Current Account USD mn	24,945	9,23	30,125	80,212	1,442	3,995	2,397	-501	-1,017	-4.436
Forex Reserves USD mn	23,530	4,946	9,792	30,291	2,426	4,747	20,989	16,664	5,688	11,185
Interest rate %	5	5.25	5	5	5	5	7.75	4.5	7.25	8.1
Money Supply (M2) USD mn	91,13	16,163	40,857	143,517	11,11	11,070	91,568	53,061	16,469	50,508
M2 Growth %	42	33	15.7	10.9	15.7	13	13.6	12.9	14.5	7
Petroleum Prdctn (ooos bpd)	2.5	8	2.45	10	220	775	740	0.3	0	0

Table 5-2 Comparative Economic indicators. Source: SHUAACAPITAL, Economic bulletin, May 31, 2006

Appendix F

Main economic indicators of Lebanon – 2001-2006

source: IMF,Banque du Liban

	2001	2002	2003	2004	2005*	2006*
GDP (at market rates,L£bn)	24,379	27,850	29,650	30,750	31,800	33,650
Year-on-year increase	-1.50%	14.20%	6.50%	3.70%	3.40%	5.80%
GDP growth+inflation	1.30%	5.50%	5%	6.40%	2.90%	6%
Year-on-year increase	-84.30%	38.60%	77.40%	172.50%	84.90%	0
GDP (at market prices,$bn)	16.2	18.5	19.7	20.4	21.1	22.3
GDP (at market rates,L£bn)	26,129	26,132	26,147	26,160	0	0
Nominal GDP (at market prices,$bn)	17.3	17.3	17.3	17.4	0	0
Real GDP Growth	0.80%	1.50%	2.50%	4.40%	0.50%	3%
Consumer price inflation	0.50%	4%	2.50%	2%	2.40%	3%
Population (m)	3.5	3.6	3.6	3.7	3.7	3.8
GDP per capita ($)	4620.4	5131.7	5463.4	5513	5701.2	5874.1
Exports Free on Board ($m)	889.3	1046	1524	1747	1800	1900
Imports Free on Board ($m)	-7083.4	-6262	-6969	-9129	-8900	-9500
Reserves excluding gold ($m)	5013.8	7244	12,519	11,735	0	0
Trade balance ($m)	-6194	-5216	-5445	-7382	-7100	-7600
Total external debt ($bn)	15	19.7	20.8	23.9	26	27.2

From: Oxford Business Group, Emerging Lebanon 2006.
* OBG Forecasts

Table 5-3 Lebanon economic indicators: OBG-Emerging Lebanon 2006.

Appendix G

Islamic funds available as of 2002

Islamic funds as of 2002- source www.failaka.com							
	Fund Name	**Fund Manager(s)**	**Manager Location**	**Fund Promoter(s)**	**Promoter Location**	**Inception Date**	**Assets ($millions)**
Global Equity Funds							
1	Al Baraka Global Equity	Merril Lynch Mercury Asset Mgmt	UK	Al Baraka Investment Bank	Bahrain	Dec-97	5.3
2	Al Rajhi Global Equity	UBS Asset Management	Switzerland	Al Rajhi Banking & Investment	Saudi Arabia	Jul-96	25
3	Al-Ahli Global Trading Equity	Wellington Management Co. LLP	USA	National Commercial Bank (NCB)	Saudi Arabia	Jan-95	336.5
4	Al-Bait Global Equity	Fremont Investment Advisors Inc.	USA	Securities House	Kuwait	Apr-00	9
5	Al-Bukhari Global Equity	Wafra Investment Advisory Group	USA	Wafra Investment Advisory Group	USA	Aug-98	4.3
6	Al-Dar World Equities	Pictet & Cie	Switzerland	Pictet & Cie	Switzerland	Feb-98	34.6
7	Alfanar Investment Holdings	AIH Investment Management Company Ltd.	USA	Permal Asset Management	USA	Dec-97	174
8	Al Kawthar Fund	Wellington/Al-Ahli Global Trading Eq.	US/Saudi Arabia	National Bank of Kuwait	Kuwait	Jan-95	-
9	Al-Khair Global Equity Fund	Pictet & Cie	Switzerland	Bank Al-Jazira	Saudi Arabia	Sep-98	15
10	Al-Safwa International Equity	Roll & Ross Asset Management	USA	Al-Tawfeek Co. for Investment Funds	Saudi Arabia	May-96	5
11	Arab Investor Crescent Fund	Schroder Investment Mgmt Int'l	UK	Arab National Bank	Saudi Arabia	Apr-99	20

12	Arzaq Investment Fund	Multi-Manager	USA/Kuwait	Securities House	Kuwait	Mar-98	8
13	Barclays Global Equity	Wellington Management Co. LLP	USA	Barclays Private Bank	UK/UAE	Feb-00	-
14	Caravan Fund	Wellington Management Co. LLP	USA	Commercial Bank of Qatar/BNP	Qatar/France	Dec-99	-
15	Citi Global Portfolios	Citi Asset Management Group	London	Citi Islamic Investment Bank	Bahrain	Oct-97	22.5
16	Dow Jones Islamic Index Fund	Brown Brothers Harriman & Co.	USA	Wafra Invest. Advisory / AlTawfeeq	US/Saudi Arabia	Jul-99	16.3
17	Hegira Global Equity	Wellington Management Co. LLP	USA	Wellington Management Co. LLP	USA	Sep-96	30.7
18	HSBC Amanah Global Equity	HSBC Investment Funds (Lux.) SA	Luxembourg	HSBC Amanah Finance	UAE	May-00	3.4
19	Mendaki Global Fund	DBS Asset Management	Singapore	Mendaki Holdings Pte. Ltd.	Singapore	Sep-97	0.5
20	Miraj Global Equity	Royal Bank of Canada	Canada	Miraj International Investment Ltd.	Canada	Aug-98	4.3
21	Musharaka Equity Fund	N/A	N/A	Riyad Bank	Saudi Arabia	Jun-97	15
22	Oasis Crescent Global Equity	Oasis Global Management Co.	Guernsey	Oasis Global Management Co.	Guernsey	Dec-00	11.6
23	Parsoli Global Equity	Capel Cure Sharp. Ltd.	UK	Parosoli Capital & City Financial Mgrs.	UK	1-May	1.5
24	QIB Global Equities	Global Asset Management (GAM)	UK	Qatar Islamic Bank	Qatar	N/A	10
25	SUT Ethical Growth Fund	Singapore Unit Trust Ltd.	Singapore	Malayan Banking & Daiwa Securities	Singapore	1-Aug	23

26	SUT Ethical Value Fund	Singapore Unit Trust Ltd.	Singapore	Malayan Banking & Daiwa Securities	Singapore	1-Aug	28.9
27	TAIB Crescent Global Fund	Albert Asset Management	USA	TAIB Bank of Bahrain	Bahrain	Mar-00	2.4
28	Takaful Global Fund	Keppel Investment Management	Singapore	Keppel Insurance Pte Ltd.	Singapore	Sep-95	82.8
29	Noriba Global Equity	UBS Islamic Fund Management Co.	Luxembourg	Noriba Bank EC	Bahrain	May-00	19.8
North American Equity Funds							
30	Al-Ahli US Trading Equity	INVESCO Capital Mgmt Inc.	USA	National Commercial Bank (NCB)	Saudi Arabia	Dec-92	49.9
31	Alfanar US Capital Growth	Forstmann-Leff Associates LLC	USA	Permal Asset Management	USA	Jun-99	10
32	Alfanar US Capital Value	Apex Capital LLC	USA	Permal Asset Management	USA	May-99	45
33	Alfanar US Large Cap	WP Stewart Asset Management	USA	Permal Asset Management	USA	Jun-99	52
34	Amana Growth *	Saturna Capital	USA	Amana Mutual Funds Trust	USA	Feb-94	20
35	Amana Income *	Saturna Capital	USA	Amana Mutual Funds Trust	USA	Jun-86	18
36	Azzad DJIM Index Fund *	Wright Investors' Service	USA	Azzad Asset Management	USA	Dec-00	0.7
37	Azzad Income Fund *	Azzad Asset Management	USA	Azzad Asset Management	USA	1-Sep	0.3
38	Dow Jones Islamic Index (US) Fund *	Allied Asset Advisors Funds	USA	Allied Asset Advisors Funds	USA	Jun-00	16
39	SAMI Fund	Dynamic Mutual Funds Ltd.	Canada	StrategicNova Funds Management Inc.	Canada	Jul-99	1.1
European Equity Funds							

40	Al-Ahli Europe Trading Equity	Gulf Int'l Bank (UK) Ltd.	UK	National Commercial Bank (NCB)	Saudi Arabia	Nov-94	53.4
41	Al-Dar Europe Equities	Pictet & Cie	Switzerland	Pictet & Cie	Switzerland	Feb-98	16.3
42	Alfanar Europe	TT International Investment Management	USA	Permal Asset Management	USA	Jan-99	51
43	Al-Sukoor European Equity	CICM Fund Management Ltd.	Ireland	Commerz Bank/Burgan Bank/Al-Tawfeek	Germany/Gulf	Mar-00	15.2
44	Al-Thoraiya European Equity	Lombard Odier & Cie	Switzerland	Bank Al-Jazira	Saudi Arabia	Sep-99	10
				Asian Equity Funds			
45	Al-Ahli Asia Pacific Trading Equity	Gulf Int'l Bank (UK) Ltd.	UK	National Commercial Bank (NCB)	Saudi Arabia	May-00	30.3
46	Al-Mashariq Japanese Equity	Julius Bär Asset Management	UK	Bank Al-Jazira	Saudi Arabia	Apr-00	6
47	Al-Nukhba Asian Equity	Nomura Investment Bank	Japan	Al-Tawfeek Co. for Investment Funds	Saudi Arabia	Jul-98	7
48	Mendaki Growth Fund	DBS Asset Management	Singapore	Mendaki Holdings Pte. Ltd.	Singapore	May-91	1.7
				Malaysian Equity Funds			
49	Abrar Investment Fund	Abrar Unit Trust Managers	Malaysia	Abrar Unit Trust Managers	Malaysia	Jun-96	161
50	Amanah Saham Bank Islam	BIMB Unit Trust Mgmt Bhd.	Malaysia	Bank Islam Malaysia Bhd	Malaysia	Jun-94	
51	Amanah Saham Darul Iman	PTB Amanah Saham Darul Iman	Malaysia	PTB Amanah Saham Darul Iman	Malaysia	Oct-94	
52	Amanah Saham Wanita	Hijrah Unit Trust Management Bhd	Malaysia	Hijrah Managers Bhd	Malaysia	May-98	

53	BBMB Dana Putra	BBMB Unit Trust Management	Malaysia	BBMB Unit Trust Management	Malaysia	Jun-96	
54	BHLB Dana Al-Ihsan	BHLB Pacific Trust	Malaysia	BHLB Pacific Trust	Malaysia	May-98	
55	Dana Al-Aiman	ASM Mara Unit Trust Management	Malaysia	ASM Mara Unit Trust Management	Malaysia	May-68	
56	HLB Dana Makmur Fund	HLB Unit Trust Management Bhd	Malaysia	HLB Unit Trust Management Bhd	Malaysia	1-Nov	
57	Kuala Lumpur Ittikal Fund	Kuala Lumpur Mutual Funds	Malaysia	Kuala Lumpur Mutual Funds	Malaysia	May-97	
58	Mayban Dana Yakin	Mayban Management Bhd.	Malaysia	Mayban Management Bhd.	Malaysia	Nov-00	
59	Pacific Dana Amana	Pacific Mutual Fund Trust	Malaysia	Pacific Mutual Fund Trust	Malaysia	Apr-98	51.1
60	RHB Mudarabah Fund	RHB Unit Trust Management	Malaysia	RHB Unit Trust Management	Malaysia	May-96	
61	Tabung Amanah Bakti	Asia Unit Trust Berhad	Malaysia	Tabung Amanah Bakti	Malaysia	May-71	
62	Tabung Ittikal Arab-Malaysian	Arab-Malaysian Unit Trusts Bhd	Malaysia	Arab-Malaysian Unit Trusts Bhd	Malaysia	Jan-93	
			Emerging Market & Country Funds				
63	Al Arabi Saudi Co. Shares	Arab National Bank	Saudi Arabia	Arab National Bank	Saudi Arabia	May-93	10
64	Al Rajhi Local Share Fund (Saudi)	Al Rajhi Banking & Investment	Saudi Arabia	Al Rajhi Banking & Investment	Saudi Arabia	Jul-92	10
65	Al Rajhi Middle East Equity	Bakheet Financial Advisors	Saudi Arabia	Al Rajhi Banking & Investment	Saudi Arabia	May-98	10
66	Al-Ahli Saudi Trading Equity	Bakheet Financial Advisors	Saudi Arabia	National Commercial Bank (NCB)	Saudi Arabia	Jun-98	10

67	Al-Dar Eastern Europe Equities	Pictet & Cie	Switzerland	Pictet & Cie	Switzerland	Feb-98	18.6
68	Al-Taiyibat Fund (Saudi)	Bank Al-Jazira Investment Services	Saudi Arabia	Bank Al-Jazira	Saudi Arabia	Sep-98	10
69	First Arabian Equity 2000	First Investment Funds E.C.	Kuwait	First Investment Company	Kuwait	1-Apr	7.9
70	Ibn Majid Emerging Markets	UBS Brinson	Switzerland	The International Investor	Kuwait	Nov-95	6.4
71	Oasis Crescent Fund (S. Africa)	Oasis Asset Management Ltd.	South Africa	Oasis Asset Management Ltd.	South Africa	Aug-98	51.7
72	Parsoli Islamic Equity (India)	Parosoli Capital & Finance Ltd.	India	Parosoli Capital & Finance Ltd.	India	1996	2
73	FutureGrowth AlBaraka Equity	Fraters Asset Management	South Africa	Futuregrowth Unit Trust / AlBaraka	South Africa	Jun-92	12.1
74	Riyad Equity Fund 2 (Saudi)	Riyad Bank	Saudi Arabia	Riyad Bank	Saudi Arabia	Nov-96	10
Small Cap, Tech. & Healthcare Funds							
75	Al Rajhi Small Companies	Franklin Mgmt & Lord Abbott	USA	Al Rajhi Banking & Investment	Saudi Arabia	Jun-99	45
76	Al-Ahli Healthcare Trading Equity	Wellington Management Co. LLP	USA	National Commercial Bank (NCB)	Saudi Arabia	Oct-00	53.4
77	Al-Ahli Small-Cap Trading Equity	Wellington Management Co. LLP	USA	National Commercial Bank (NCB)	Saudi Arabia	Aug-98	135
78	Alfanar Global Healthcare	Essex Investment Management LLC	USA	Permal Asset Management	USA	Dec-00	32
79	Alfanar Technology	Essex Investment Management LLC	USA	Permal Asset Management	USA	Jun-99	17

80	Al Kawthar Healthcare Fund	Wellington/Al-Ahli Global Trading Eq.	US/Saudi Arabia	National Bank of Kuwait	Kuwait	Nov-00	-
81	TII Small Cap Equity (European)	Pictet Asset Management Ltd.	UK	The International Investor	Kuwait	Dec-96	0.5
Balanced, Secured & Other Funds							
82	Al Hilal Fund (Balanced)	Merril Lynch Mercury Asset Mgmt	UK	Abu Dhabi Islamic Bank (ADIB)	UAE	Apr-00	16.5
83	Al Kawthar Global Equity Secured	Wellington/Al-Ahli Global Trading Eq.	US/Saudi Arabia	National Bank of Kuwait	Kuwait	Sep-99	-
84	Al Rajhi Balanced Fund I	Al Rajhi Banking & Investment	Saudi Arabia	Al Rajhi Banking & Investment	Saudi Arabia	Nov-98	35
85	Al Rajhi Balanced Fund II	Al Rajhi Banking & Investment	Saudi Arabia	Al Rajhi Banking & Investment	Saudi Arabia	Dec-98	32
86	Al-Ahli Europe Equity Secured	Deutche Bank	Germany	National Commercial Bank (NCB)	Saudi Arabia	Jun-00	50
87	Al-Ahli International Equity Secured	Deutche Bank	Germany	National Commercial Bank (NCB)	Saudi Arabia	Feb-00	35.7
88	Al-Ahli Global Equity Secured	Wellington Management Co. LLP	USA	National Commercial Bank (NCB)	Saudi Arabia	Apr-99	150
89	Al-Ahli US Equity Secured	Deutche Bank	Germany	National Commercial Bank (NCB)	Saudi Arabia	Oct-99	50
90	Alkhawarizmi Fund (Mkt. Neutral)	AXA Rosenberg	UK	The International Investor	Kuwait	Jul-97	9.3
91	Amanah European Basket Protected	HSBC Amanah Finance	UAE	HSBC Bank Middle East	UAE	1-Nov	20
92	Amanah Global Titans Protected	HSBC Amanah Finance	UAE	HSBC Bank Middle East	UAE	2-Mar	-
93	BHLB Pacific Dana Al-Mizan (Balanced)	BHLB Pacific Trust	Malaysia	BHLB Pacific Trust	Malaysia	1-Mar	-
94	Faysal Shield Fund	BNP Paribas	France	Shamil Bank of Bahrain	Bahrain	Nov-99	25

	(Secured)						
95	Mendaki Capital Protected Fund	DBS Asset Management	Singapore	Medaki Holdings Pte Ltd.	Singapore	Dec-00	20
96	Takaful Sinaran (Global Equity Hedge)	Keppel Investment Management	Singapore	Keppel Insurance Pte Ltd.	Singapore	Sep-00	3.8
97	Profit Sharing Fund (Aman-1) (Secured)	Al Rajhi Banking & Investment	Saudi Arabia	Al Rajhi Banking & Investment	Saudi Arabia	N/A	50
Islamic Bond (Sukuk) Funds							
98	RHB Islamic Bond Fund	RHB Unit Trust Management	Malaysia	RHB Unit Trust Management	Malaysia	Jun-00	30
99	Kuala Lumpur Islamic Bond Fund	Kuala Lumpur Mutual Funds	Malaysia	Kuala Lumpur Mutual Funds	Malaysia	1-Aug	20
100	Dahlia Syariah Income Fund	Mayban Life Assurance Bhd.	Malaysia	Mayban Life Assurance Bhd.	Malaysia	1-Aug	20

Table 5-4 Available Islamic Funds as of 2002- SOURCE: www.failaka.com

Appendix H

Profile and Private Infrastructure Project Finance Structures and Relevant Contracts

	Structure	Description
1.	**Build Operate and Transfer (BOT)**	It is a concession agreement, between an entity representing the public authority and a private party whereby the private party constructs and operates an infrastructure facility for a fixed time period and after that time period the ownership of minimal financial obligations. The project specifications are made by the public authorities and the project development and operation is carried out by the private party with full capital cost and expected earnings from the project revenues during the period of the concession. The purchase of project output is guaranteed by the government at a specified fixed price. The public authorities provide limited or no financial accommodation but substantial market and over risk coverage and guaranties. The whole process involves several contracts for sharing the risks, liabilities, responsibilities and returns. The arrangement enables the governments to facilitate the development of infrastructure projects without recourse to the government budget.
2.	**Build Operate & Renewal of concession (BORC)**	BORC is a more efficient variant of the BOT. It is a BOT, but with an option to re-negotiate the agreement of renewal of contract for operation at the end of a contract period. As a result of the negotiation operation will either remain with the same project company or the ownership will be transferred to the public authority. This option makes the contract flexible and efficient provided the obligations and risk sharing processes are clearly defined, understood and implemented.
3.	**Build Own and Operate (BOO)**	BOO is BOT variant as far as the specifications and obligations are concerned. However, generally BOOs are permanent franchises in which the private party keeps ownership until its performance on obligations is seen satisfactory by the public authority. In this sense it is a hybrid of BOT and BORC.
4.	**Build transfer and operate (BTO)**	BTO is a short term BOT with a long term franchise for operation by the same private party. Hence the private party will design, finance, and develop the project on orders from public authorities and transfer the ownership of completed project to the public authorities on turnkey basis. Operation of the project will however, remain with the private party for a specified period for feels revenues sharing etc. during the post transfer operational

		phase; the financial obligations of public authority will be limited.
5.	**Build Transfer and Lease Back (BTLB)**	BLTB is a BTO but leased back to the private party for a specified time.
6.	**Buy Build & Operate (BBO)**	In BBO an existing public project is bought by a private firm and rehabilitated, enhanced and operated by the private party. The specifications for rehabilitations and enhancements are made by the public authority. Like BOO, under BBO too, the unlimited duration of operation in linked to compliance with contracts.
7.	**Lease, Develop, Operate (LDO)**	LDO is a comprehensive lease of an existing facility plus its surroundings after which the private party develops the area subject to approval of the public authority and operates the facility. It can be considered a fixed term revenue sharing contract.
8.	**Rehabilitate, Own and Operate (ROO)**	Under an ROO an existing public project is given over to a private firm for rehabilitation according to specifications. The private firm will own the project until it meets the initial conditions.
9.	**Rehabilitate, Operate and Transfer (ROT)**	ROT is a fixed term concession like the BOT but the object is an existing public sector project and the objective is its rehabilitation and enhancement. Other than that, all conditions of the BOT may apply.
10.	**Temporary Privatization**	Existing public property is taken over by a private firm for a known period. The private firm undertakes renovation, expansion etc. The private firm fully and independently utilizes the project and bears all risks for a specified period.
11.	**Transfer of Operational Rights (TOR)**	Private company receives an existing facility against a transfer fee in favor of the government, manages, operates, maintains, invests and finances on the facility during the period and at the end of the TOR period returns facility back without any cost or liability.
12.	**Turnkey Contracts**	Construction and transferring over to one party by another party a project for a specified price and subject quality and technology specifications.
13.	**Construction Contract**	Contract(s) for the construction of the project on turnkey or production – in- hand basis.
14.	**Take-or-Pay Contract**	The public authority as purchaser of the services generated by a BOT or its variant, agrees to pay specified amounts even if sometimes the public utility may not receive back from the users what it pays for to the BOT company. It is used as an incentive and risk coverage by public authority to private firm to develop projects with public specifications
15.	**Off – take Contract**	Agreement for the purchase of the output of a project for a specified price for a specified period- e.g. , a power purchase agreement (PPA)
16.	**Power Purchase Agreement**	In the public facilitated private power projects, the Government guarantees to purchase electricity at specified price for specified time. This covers the producer's market risk.

	(PPA)	
17.	**Operation & Maintenance (O&M) Contract**	Contractors or other parties take the responsibility of the operational efficiency and maintenance of a BOT project. In this way, the risk of the private party with regard to operation and maintenance is covered.

Source: Munawar Iqbal and Tariqullah Khan (2004), "Financial Public Expenditure: an Islamic Perspective", *Islamic development Bank Group, Islamic Research & Training Institute* Jeddah-Saudi Arabia, p.77.

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